

**Social Market Economy  
History, Principles and  
Implementation –  
From A to Z**



# **Social Market Economy History, Principles and Implementation – From A to Z**

Edited by  
Rolf H. Hasse, Hermann Schneider & Klaus Weigelt

English edition

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ISBN: 978-0-9802543-7-2

Produced by:  
Konrad-Adenauer-Stiftung  
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Dunkeld 2196  
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*Translator:* Vera Leckie  
*Language editors:* Tracy Seider and Richard Proctor-Sims  
*Layout and production:* Tyrus Text and Design, South Africa  
*Printing:* Paarl Print, South Africa

First published in German: *Lexikon Soziale Marktwirtschaft – Wirtschaftspolitik von A bis Z*

ISBN 3-506-97018-6

© 2002 Verlag Ferdinand Schöningh GmbH, Paderborn, Germany  
Second updated and extended edition, 2005

## The editors

**Prof. Dr Rolf H. Hasse** was born in Berlin in 1940. He completed his undergraduate studies in economics in Münster, Westphalia and Cologne. Hasse graduated in 1967 and completed his doctorate (1973) and post-doctoral qualification (1981) in Cologne. From 1981 to 1998 he was Professor of Economics, in particular economic policy, at the University of the Federal Armed Forces in Hamburg. Hasse was at the University of Leipzig from September 1998 to March 2006. Since March 2006 he has been acting manager of Fraunhofer-Zentrum für Mittel- und Osteuropa (MOEZ), Leipzig. His main focus of research and publications include economic policy, international business relations and European integration.

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**Dip Vw (Master in Economics) Klaus Weigelt** was born in Königsberg, Prussia, in 1941. He is an economist (Freiburg), and since 1971 he has been a KAS research associate both in Germany and abroad. Weigelt was director of the KAS Academy for 11 years (1981–1992), KAS national representative in Caracas, Venezuela (1975–1981), director of the KAS European Office in Brussels (1992–1998), and director of the KAS foreign branch in Budapest, Hungary (2002–2007). The main focus of his publications is institutional order policy and economic ethics in the social market economy.



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## Preface

After half a century of economic policy under the banner of the social market economy, the vast majority of Germans have accepted this as their country's economic order. This is particularly due to the consistent implementation of the institutional order (*Ordnungs*) concept and the resulting rapid economic and social successes in the initial phases of the Federal Republic. However, insight into the context and functioning of the social market economy has declined considerably over the years, while its interpretation has become highly arbitrary. Vital institutional order policy principles of the social market economy have thus been diluted beyond recognition. In public debate the social market economy has become almost an empty formula that is used by all and sundry. In this way, the model of the social market economy has become an example of the continuation of an idea, even though its fundamental principles are often flawed in their implementation and its core is under threat.

Economic policy in Germany is faced with enormous problems. At present, neither its economic aims nor its social aims are being satisfactorily achieved. Unresolved problems range from long-term unemployment to increasing demands on the welfare system, the dangers of renewed inflation and the unanswered questions relating to an economic policy in a European context, as well as the worldwide challenges of globalisation, environmental problems and poverty. The social market economy in its conceptual form can offer answers to these questions and problems; however, these answers have become obscured, with the result that they are no longer clearly visible and are therefore not sufficiently used. The German and European economic policies are looking for direction and are currently going through an institutional order policy crisis.

The aim of this volume is to clarify the concept of the social market economy in terms of economic and social policy and its political implementation. On the one hand, it is an attempt to retrace the origins and basic principles of the social market economy. On the other, it presents the different forms of social market economy, the need for adaptation in the light of recent challenges, the objections to social market economy and its prospects as a future economic and social system.

The book is aimed at the younger generation, which has the impartiality, openness and critical attitude necessary for implementing reforms, as well as an openness to conceptual orientation.

The editors and contributors have tried to summarise the essential aspects in short articles and to formulate the sometimes difficult factual issues in comprehensible

language. Cross-referencing makes the book more user-friendly, while a glossary is included for the explanation of specialised terms and their relevance.

In terms of work on the original German version, the editors are particularly grateful to Prof. Dr Hans Willgerodt for his suggestions regarding the conceptual unity of this work, to Marina Ignatjuk for her diligent work in coordinating and editing the contributions, and to Wolfgang Reeder for selecting the illustrations and diagrams.

The editors would like to thank all the contributors for their punctual and diligent work. Particular thanks go to Joachim Hummel who managed and coordinated the complicated task of editing the original German second edition. Furthermore, we would like to thank the staff of the Institute for Economic Policy at the University of Leipzig and the Konrad-Adenauer-Stiftung (KAS) in St. Augustin, which have both contributed to the book's success in many ways.

This English version is based on the second edition (2005) of the original German work, with updates where relevant. At a time of international upheaval of institutions and structures, its content responds to the lively interest in this subject as well as providing invaluable information on institutional order policy (*Ordnungspolitik*).

Regarding this English version, we must acknowledge the translator Dr Vera Leckie and the English language editors Tracy Seider and Richard Proctor-Sims for their diligence and commitment to this challenging task.

The editors would also like to thank the KAS Johannesburg office staff for their constructive collaboration in producing the English version of this book. KAS head office deserves thanks for its immediate and positive response to the idea, for its encouragement and support while the work was in progress, as well as for providing the necessary funds.

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*Leipzig*

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*Bonn*

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## **Contents**

<b>Alphabetical list of biographies and themes</b>	<b>11</b>
<b>Biographies</b>	<b>27</b>
<b>Themes</b>	<b>79</b>
<b>Glossary</b>	<b>477</b>
<b>Sub-division of themes</b>	<b>495</b>
<b>Abbreviations</b>	<b>503</b>
<b>List of tables, figures and other illustrations</b>	<b>505</b>
<b>List of contributors</b>	<b>507</b>
<b>Index</b>	
Biographies and other personalities	515
Themes	517
<b>Appendix</b>	
Selected German economic research and advisory institutions	530



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## Alphabetical list of biographies and themes

### Biographies

<b>Beckerath</b> , Erwin von <i>Norbert Kloten</i>	27
<b>Böhm</b> , Franz <i>Ulrich Immenga</i>	29
<b>Briefs</b> , Goetz A. <i>Anton Rauscher</i>	30
<b>Dietze</b> , Constantin von <i>Nils Goldschmidt</i>	31
<b>Einaudi</b> , Luigi <i>Hans Willgerodt</i>	32
<b>Engels</b> , Wolfram <i>Rolf H. Hasse</i>	33
<b>Erhard</b> , Ludwig Wilhelm <i>Rainer Klump</i>	34
<b>Eucken</b> , Walter Kurt Heinrich <i>Lüder Gerken</i>	36
<b>Frickhöffer</b> , Wolfgang <i>Joachim Starbatty</i>	39
<b>Hayek</b> , Friedrich August von <i>Gerd Habermann</i>	40
<b>Hensel</b> , K. Paul <i>Gernot Gutmann</i>	42
<b>Höffner</b> , Joseph Kardinal <i>André Habisch</i>	43

<b>Kamitz</b> , Reinhard <i>Wolfgang Schmitz</i>	45
<b>Karrenberg</b> , Friedrich <i>Martin Honecker</i>	47
<b>Lutz</b> , Friedrich August <i>Vereina Veit-Bachmann</i>	47
<b>Meyer</b> , Fritz W. <i>Helmut Gröner</i>	49
<b>Miksch</b> , Leonhard <i>Heinz-Dieter Smeets, Michael Sket</i>	50
<b>Müller-Armack</b> , Alfred <i>Friedrun Quaas</i>	52
<b>Nell-Breuning</b> , Oswald von <i>Lothar Roos</i>	53
<b>Nipperdey</b> , Hans Carl <i>Hans-Jürgen Papier</i>	57
<b>Röpke</b> , Wilhelm <i>Hans-Günter Krüsselberg</i>	58
<b>Rueff</b> , Jacques <i>Josef Molsberger</i>	60
<b>Rüstow</b> , Alexander <i>Jan Hegner</i>	63
<b>Schiller</b> , Karl <i>Egon Tuchfeldt</i>	65
<b>Schleyer</b> , Hanns-Martin <i>Franz Schoser</i>	67
<b>Schmölders</b> , Günter <i>Horst Zimmermann</i>	67
<b>Schreiber</b> , Wilfrid <i>Heinz Lampert</i>	68

<b>Stoltenberg, Gerhard</b> <i>Peter Wichert</i>	<b>70</b>
<b>Stützel, Wolfgang</b> <i>Peter Bofinger</i>	<b>72</b>
<b>Thielicke, Helmut</b> <i>Rolf Kramer</i>	<b>74</b>
<b>Veit, Otto</b> <i>Hans Jörg Thieme</i>	<b>75</b>
<b>Welter, Erich</b> <i>Walter Hamm</i>	<b>77</b>

## Themes

<b>Accident insurance</b>	79
<i>Albrecht Bossert</i>	
<b>Achievement principle</b>	80
<i>Hans Willgerodt</i>	
<b>Act Against Restraints of Competition</b>	81
<i>Kurt Stockmann</i>	
<b>Agricultural policy</b>	83
<i>Stefan Tangermann</i>	
<b>Balance of payments equilibrium</b>	85
<i>Marcus Cieleback</i>	
<b>Banking system, structure and supervision</b>	86
<i>Stephan Paul, Peter T. Baltes</i>	
<b>Basic rights, the Basic Law and social market economy</b>	89
<i>Hans Willgerodt</i>	
<b>Basic social security</b>	91
<i>Jörg Althammer</i>	
<b>Business accountancy: Basic concepts</b>	93
<i>Marc Richard</i>	
<b>Business cycles</b>	95
<i>Adolf Wagner, Sabine Klinger</i>	
<b>Business cycle policy</b>	96
<i>Adolf Wagner, Sabine Klinger</i>	
<b>Capital markets</b>	98
<i>Stephan Paul</i>	
<b>Catholic social doctrines</b>	100
<i>Lothar Roos</i>	
<b>Chamber system</b>	103
<i>Hans Werner Hinz</i>	

---

<b>Chambers of commerce and industry</b> <i>Dagmar Boving</i>	<b>104</b>
<b>Circular flow of incomes, national income and national product</b> <i>Adolf Wagner, Sabine Klinger</i>	<b>106</b>
<b>Co-determination</b> <i>Gernot Fritz</i>	<b>107</b>
<b>Collective agreements</b> <i>Gernot Fritz</i>	<b>109</b>
<b>Competition</b> <i>Hans Peter Seitel</i>	<b>111</b>
<b>Concentration</b> <i>Kurt Stockmann</i>	<b>114</b>
<b>Concerted Action and Alliance for Employment (Konzertierte Aktion/Bündnis für Arbeit)</b> <i>Walter Hamm</i>	<b>116</b>
<b>Conflicting aims in economic policy</b> <i>Thomas Apolte</i>	<b>118</b>
<b>Conservatism</b> <i>Klaus Weigelt</i>	<b>120</b>
<b>Constructivism</b> <i>Christian Watrin</i>	<b>122</b>
<b>Consumer policy</b> <i>Wolfgang Reeder</i>	<b>126</b>
<b>Council of Experts</b> <i>Martin Wolburg</i>	<b>128</b>
<b>Currency system and exchange rate regimes</b> <i>Wolf Schäfer</i>	<b>129</b>
<b>Demographic development</b> <i>Thomas Straubhaar</i>	<b>131</b>

<b>Deregulation</b>	135
<i>Juergen B. Donges</i>	
<b>Development aid, development policy</b>	137
<i>Hans-Rimbert Hemmer</i>	
<b>Distribution</b>	139
<i>Jürgen Siebke</i>	
<b>Economic ethics</b>	141
<i>Ingo Pies, Alexandra von Winning</i>	
<b>Economic orders: Theory and implementation</b>	143
<i>Helmut Leipold</i>	
<b>Education and research policy</b>	146
<i>Ulrich van Lith</i>	
<b>Education funding</b>	148
<i>Ulrich van Lith</i>	
<b>Employment</b>	153
<i>Ansgar Belke, Frank Baumgärtner</i>	
<b>Employment policy</b>	157
<i>Ansgar Belke</i>	
<b>Enterprise, plant</b>	159
<i>Kurt J. Lauk, Rainer Gerding</i>	
<b>Entrepreneur, manager</b>	161
<i>Kurt J. Lauk, Rainer Gerding</i>	
<b>Environmental impact</b>	163
<i>Paul Klemmer</i>	
<b>Environmental policy: Actors</b>	165
<i>Bernd Hansjürgens</i>	
<b>Environmental policy: Conflicting aims</b>	167
<i>Eberhard Feess</i>	
<b>Environmental policy: Instruments</b>	167
<i>Alfred Endres</i>	



---

<b>Environmental protection objectives</b>	<b>169</b>
<i>Fritz Söllner</i>	
<b>Environment-oriented management</b>	<b>171</b>
<i>Ulrich Steger</i>	
<b>European Central Bank, German Federal Bank</b>	<b>172</b>
<i>Reiner König</i>	
<b>European Economic and Monetary Union</b>	<b>174</b>
<i>Rolf H. Hasse</i>	
<b>European monetary policy: Actors</b>	<b>178</b>
<i>Diemo Dietrich</i>	
<b>European monetary policy: Aims and duties</b>	<b>179</b>
<i>Diemo Dietrich</i>	
<b>European monetary policy: Instruments</b>	<b>180</b>
<i>Diemo Dietrich</i>	
<b>European monetary policy: Strategies</b>	<b>182</b>
<i>Diemo Dietrich</i>	
<b>EU: Agricultural policy and enlargement east</b>	<b>183</b>
<i>Stefan Tangermann</i>	
<b>EU: Budgeting</b>	<b>186</b>
<i>Alexander Schumann</i>	
<b>EU: Competition policy</b>	<b>190</b>
<i>Peter Behrens</i>	
<b>EU: Education and research policy</b>	<b>192</b>
<i>Ulrich van Lith</i>	
<b>EU: Employment policy</b>	<b>194</b>
<i>Ansgar Belke</i>	
<b>EU: Enlargement</b>	<b>197</b>
<i>Wolfgang Wessels, Jürgen Mittag</i>	
<b>EU: Environmental policy</b>	<b>200</b>
<i>Helmut Karl</i>	

<b>EU: History</b>	202
<i>Melanie Piepenschneider</i>	
<b>EU: Industrial, research and technology policy</b>	203
<i>Joachim Starbatty, Andreas Schumm</i>	
<b>EU: Maxims for action</b>	206
<i>Hans-Eckkart Scharrer</i>	
<b>EU: Organs and institutions</b>	208
<i>Wolfgang Wessels, Jürgen Mittag</i>	
<b>EU: Reforms and consolidation – economic aspects</b>	211
<i>Daniel Piazzolo</i>	
<b>EU: Reforms and consolidation – political aspects</b>	214
<i>Wolfgang Wessels, Jürgen Mittag</i>	
<b>EU: Regional and structural policy</b>	217
<i>Reiner Martin</i>	
<b>EU: Social policy</b>	220
<i>Hans Jürgen Rösner</i>	
<b>EU: Trade policy</b>	222
<i>Detlef Böhle</i>	
<b>EU: Transport policy</b>	224
<i>Karl-Hans Hartwig</i>	
<b>Family policy</b>	226
<i>Hans Jürgen Rösner</i>	
<b>Federal Cartel Office</b>	227
<i>Kurt Stockmann</i>	
<b>Federal Employment Agency</b>	229
<i>Gerhard D. Kleinhenz</i>	
<b>Federal Republic (<i>Bund</i>), federal states (<i>Länder</i>) and municipalities</b>	232
<i>Klaus Dieter Diller</i>	
<b>Financial constitution</b>	233
<i>Dietrich Dickertmann, Peter T. Baltes</i>	

---

<b>Fiscal federalism</b>	<b>235</b>
<i>Dietrich Dickertmann, Peter T. Baltes</i>	
<b>Foreign trade</b>	<b>238</b>
<i>Markus Neimke</i>	
<b>Globalisation</b>	<b>241</b>
<i>Heinz Gert Preuße</i>	
<b>Growth</b>	<b>245</b>
<i>Günter Gabisch</i>	
<b>Health insurance</b>	<b>247</b>
<i>Albrecht Bossert</i>	
<b>Housing policy: New federal states (<i>Länder</i>)</b>	<b>249</b>
<i>Katrin Leonhardt</i>	
<b>Housing policy: Old federal states (<i>Länder</i>)</b>	<b>251</b>
<i>Winfried Michels</i>	
<b>Income</b>	<b>254</b>
<i>Jörg Winterberg</i>	
<b>Indebtedness of developing countries</b>	<b>257</b>
<i>Ronald Clapham</i>	
<b>Individual responsibility</b>	<b>260</b>
<i>Lüder Gerken</i>	
<b>Industrial action</b>	<b>261</b>
<i>Hans Jürgen Rösner</i>	
<b>Industrial policy</b>	<b>263</b>
<i>Peter Oberender, Stephan Ruckdäschel, Thomas Rudolf</i>	
<b>Industrial relations constitution</b>	<b>266</b>
<i>Gernot Fritz</i>	
<b>Institutional economics</b>	<b>267</b>
<i>Martin Leschke</i>	
<b>Institutional order policy (<i>Ordnungspolitik</i>) and process policy</b>	<b>270</b>
<i>Hans Jörg Thieme</i>	

<b>Institutional order policy (<i>Ordnungspolitik</i>): Exemptions from competition rules</b>	271
<i>Norbert Eickhof</i>	
<b>Integration</b>	274
<i>Karl Wolfgang Menck</i>	
<b>Interest groups, lobbies</b>	276
<i>Werner Lachmann</i>	
<b>International currency system</b>	278
<i>Carsten Eppendorfer</i>	
<b>International Labour Organization</b>	280
<i>Peter Clever</i>	
<b>International migrations</b>	283
<i>Thomas Straubhaar</i>	
<b>International organisations</b>	287
<i>Marina Ignatjuk</i>	
<b>Interventionism</b>	290
<i>Alfred Schüller, Thomas Welsch</i>	
<b>Keynesianism</b>	293
<i>Adolf Wagner, Sabine Klinger</i>	
<b>Labour law</b>	295
<i>Gernot Fritz</i>	
<b>Labour market order</b>	297
<i>Gerhard D. Kleinhenz</i>	
<b>Labour market policy</b>	300
<i>Rüdiger Soltwedel</i>	
<b>Liberalism</b>	303
<i>Ralph G. Andereg</i>	
<b>Managing and planning</b>	305
<i>Gernot Gutmann</i>	

---

<b>Market economy</b> <i>Joachim Starbatty</i>	<b>307</b>
<b>Market economy and public institutions</b> <i>Hans Willgerodt</i>	<b>308</b>
<b>Market mechanism</b> <i>Hermann Schneider</i>	<b>310</b>
<b>Markets and prices</b> <i>Hans Peter Seitel</i>	<b>312</b>
<b>Media policy</b> <i>Norbert Eickhof, Henning Never</i>	<b>313</b>
<b>Middle class policy</b> <i>Eberhard Hamer</i>	<b>316</b>
<b>Monetarism</b> <i>Roland Vaubel</i>	<b>317</b>
<b>Monetary order</b> <i>Wim Kösters</i>	<b>318</b>
<b>New economy</b> <i>Wolf Schäfer</i>	<b>320</b>
<b>Nursing care insurance</b> <i>Albrecht Bossert</i>	<b>321</b>
<b>Occupational health and safety</b> <i>Werner Schöning</i>	<b>323</b>
<b>Old-age pensions</b> <i>Thomas Apolte</i>	<b>325</b>
<b>Open markets: Market entry, market exit</b> <i>Dieter Fritz-Aßmus</i>	<b>327</b>
<b>Parastatals</b> <i>Dietrich Dickertmann, Viktor Wilpert Piel</i>	<b>329</b>
<b>Patent system</b> <i>Dieter Fritz-Aßmus</i>	<b>331</b>

<b>Pension insurance (additional services)</b>	333
<i>Werner Schöning</i>	
<b>Policy consulting</b>	334
<i>Stefan Okruch</i>	
<b>Political parties</b>	337
<i>Horst-Dieter Westerhoff</i>	
<b>Poverty</b>	340
<i>Horst-Dieter Westerhoff</i>	
<b>Price level stability</b>	343
<i>Heinz-Dieter Smeets</i>	
<b>Privatisation</b>	347
<i>Dietrich Dickertmann, Peter T. Baltes</i>	
<b>Production and supply</b>	349
<i>Hans Peter Seitel</i>	
<b>Profit</b>	350
<i>Marc Richard</i>	
<b>Property</b>	354
<i>Heinrich Höfer</i>	
<b>Protection of freedoms</b>	356
<i>Helmut Leipold</i>	
<b>Protestant social ethics</b>	358
<i>Martin Honecker</i>	
<b>Public debt</b>	361
<i>Dietrich Dickertmann, Annemarie Leiendecker</i>	
<b>Public enterprises</b>	363
<i>Dietrich Dickertmann, Viktor Wilpert Piel</i>	
<b>Public expenditure</b>	365
<i>Dietrich Dickertmann, Annemarie Leiendecker</i>	
<b>Public revenue</b>	367
<i>Dietrich Dickertmann, Viktor Wilpert Piel</i>	

---

<b>Public-private partnerships</b>	<b>371</b>
<i>Peter Oberender, Thomas Rudolf</i>	
<b>Reconstruction East</b>	<b>373</b>
<i>Ulrich Heilemann, Hermann Rappen</i>	
<b>Redemption Fund for Inherited Liabilities</b>	<b>375</b>
<i>Ulrich Heilemann, Hermann Rappen</i>	
<b>Resource protection</b>	<b>377</b>
<i>Klaus W. Zimmermann</i>	
<b>Reunification: Monetary, economic and social union</b>	<b>380</b>
<i>Rolf H. Hasse</i>	
<b>Reunification: Monetary union through currency conversion</b>	<b>383</b>
<i>Peter Bofinger</i>	
<b>Shadow economy</b>	<b>385</b>
<i>Wolf Schäfer</i>	
<b>Social budget</b>	<b>386</b>
<i>Jörg Althammer</i>	
<b>Social capital</b>	<b>389</b>
<i>Stefan Okruch</i>	
<b>Social justice (social balancing)</b>	<b>390</b>
<i>Friedrun Quaas</i>	
<b>Social market economy: An introduction</b>	<b>393</b>
<i>Friedrun Quaas</i>	
<b>Social market economy: Concept of man</b>	<b>395</b>
<i>Klaus Weigelt</i>	
<b>Social market economy: In the EU</b>	<b>398</b>
<i>Karl von Wogau</i>	
<b>Social market economy: Political implementation</b>	<b>401</b>
<i>Christian Otto Schlecht</i>	
<b>Social market economy: Principles and functioning</b>	<b>407</b>
<i>Dietrich Dickertmann, Viktor Wilpert Piel</i>	

<b>Social market economy: Social irenics</b>	416
<i>Friedrun Quaas</i>	
<b>Social partners</b>	418
<i>Hans Jürgen Rösner</i>	
<b>Social partnership</b>	419
<i>Hans Jürgen Rösner</i>	
<b>Social policy</b>	420
<i>Heinz Lampert</i>	
<b>Social policy: International</b>	423
<i>Hans Jürgen Rösner</i>	
<b>Social state and welfare state</b>	424
<i>Heinz Lampert</i>	
<b>Social system</b>	426
<i>Heinz Lampert</i>	
<b>Socialism/planned economy</b>	429
<i>Alfred Schüller, Thomas Welsch</i>	
<b>Societal foundation of economic orders</b>	431
<i>Friedrun Quaas</i>	
<b>Solidarity surtax</b>	433
<i>Ullrich Heilemann, Hermann Rappen</i>	
<b>Speculation</b>	435
<i>Franz-Josef Leven</i>	
<b>Statistics</b>	436
<i>Horst-Dieter Westerhoff</i>	
<b>Structural policy</b>	439
<i>Walter Hamm</i>	
<b>Subsidies, government assistance</b>	441
<i>Dietrich Dickertmann, Annemarie Leiendecker</i>	
<b>Supervisory offices</b>	443
<i>Dieter Fritz-Aßmus</i>	



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<b>Supply and demand</b>	<b>445</b>
<i>Hans Peter Seitel</i>	
<b>Sustainability</b>	<b>448</b>
<i>Rolf H. Hasse</i>	
<b>System(s) competition</b>	<b>449</b>
<i>Ronald Clapham</i>	
<b>Tax policy</b>	<b>451</b>
<i>Wolfgang Reeder</i>	
<b>Third ways: Mixed economy</b>	<b>454</b>
<i>Alfred Schüller, Thomas Welsch</i>	
<b>Transport policy</b>	<b>456</b>
<i>Karl-Hans Hartwig</i>	
<b>Treuhand Privatisation Agency (Treuhandanstalt)</b>	<b>458</b>
<i>Uwe Siegmund</i>	
<b>Types of market economy</b>	<b>460</b>
<i>Joachim Starbatty</i>	
<b>Unemployment: Causes and effects</b>	<b>463</b>
<i>Hans-Günter Krüsselberg</i>	
<b>Unemployment: Social security</b>	<b>467</b>
<i>Hans-Günter Krüsselberg</i>	
<b>Vocational training and further education</b>	<b>471</b>
<i>Ulrich van Lith</i>	
<b>Wealth accumulation policy</b>	<b>473</b>
<i>Eckhard Knappe</i>	
<b>World trade order</b>	<b>474</b>
<i>Dieter Bender</i>	



## Biographies

### **Beckerath, Erwin Emil von**

Born 31 July 1889

Died 23 November 1964

*Three historical periods influenced von Beckerath's life and career: the last decades before the First World War; the inter-war years; and the emergence of the new political and social order and the →social market economy in (Western) post-war Germany. Having grown up in one of Krefeld's great Mennonite merchant families, von Beckerath began to develop his interest in history, politics, economics and the social sciences under his academic supervisor, Dr Gustav von Schmoller. Even before the end of the war – and influenced by the academic writings of the finance and transport expert Emil Sax – von Beckerath turned his attention to the logic and clarity of the Vienna School of Marginal Utility (doctrine of subjective value). It was then that he started to teach this subject in his inimitable style, deepened by references to the great economic thinkers of every school of thought. Throughout his many years as chairperson of the Scientific Advisory Council (1948–1964), von Beckerath played a considerable role in the implementation of the concept of the social market economy.*

After 1945, von Beckerath embarked on a detailed analysis of the macro-economic ideas that John Maynard Keynes had developed during the 1930s, whose importance he recognised for economic policy (→*Keynesianism*). In the decades prior to that, he had articulated very clear ideas about the structure of a free post-war system.

The First World War marked the collapse of the old European political order that had been established in 1815 by the Congress of Vienna, with its world economic order of free trade and the gold standard. Like many others, von Beckerath asked himself how a new order could be created from the chaos. He studied the great political thinkers from Machiavelli to Tocqueville, from Marx to Max Weber, but also Bergson, Lenin, Sorel, Mosca and Robert Michels. But most of all von Beckerath studied Vilfredo Pareto and his teachings about logical and illogical actions and the 'cycles of the elites'.

Von Beckerath examined fascism in Italy, which with the *Stato Corporativo* might have qualified as a potential, albeit dictatorial, system for economy and society. However, for reasons inherent in the system and influenced by Mussolini's fateful pact with Hitler in the 1930s, this system degenerated into one of the totalitarian systems of 20th century Europe.

The Erwin von Beckerath Association thought hard about both the present and the future of a National Socialist Germany caught up in a world war. The association had been started on a quasi-private basis in March 1943, after Class XI of the German Law Academy had been closed down by a government that was growing increasingly suspicious.

After the dissolution of the Association for Social Policy (1936), Jens Jessen, executed in 1944 after the attempt on Hitler's life, had been trying to give to the economists who had lost their home base a new forum in the 'Economics Study Group', chaired by von Beckerath. In the association, Erwin von Beckerath undertook to

work out 'the principles of an economic system for the transition period from war to peace, and the shape of the new economic system after the demise of the regime'. The preliminary work of the association – today considered as one of the Freiburg resistance groups – which was already well advanced by then, came to an abrupt end with the assassination attempt on Hitler in 1944.

After the war, there were plans to resuscitate the association when on 24 January 1948, on the initiative of Ludwig →Erhard, the Economic Administration for the United Economic Zone (the economic administration for two zones) established a scientific advisory body. Its founder members →Eucken, →Böhm, Lampe, Preiser, Wessels and von Beckerath – who was quickly elected chairman – had already been part of the Erwin von Beckerath Association which was then adequately replaced by the advisory body. The advisory body, which after the establishment of the Federal Republic became affiliated with the Federal Ministry for Economic Affairs, remained the undisputed model for independent political advisory organisations in the new Germany. It sustained and inspired the birth of the social market economy with its reports, and von Beckerath remained its chairman until his death in November 1964.

After he was made professor emeritus in Bonn, von Beckerath lectured in Basel at the request of Edgar Salin, to whom he had been close since the foundation of the List Society in 1924. He was as involved in its re-establishment after the war (June 1955) as he was in the re-establishment of the Association for Social Policy (*Verein für Socialpolitik*) (16 September 1948).

Among his historical writings on doctrine and methodology, the biographical contributions are seen as models of appreciation for a scientist. Von Beckerath's discourses on the theory of economic policy and his essays on political policy are today still greatly valued.

ACADEMIC AND PROFESSIONAL CAREER: Undergraduate degree in History at Freiburg, followed by an Economics degree in Berlin. On 18 March 1912 he received his doctorate from the Friedrich-Wilhelm University in Berlin. From July 1913 until February 1915 he was assistant lecturer in the Department of Economics at the University of Leipzig. From February 1915 until January 1916, military service; subsequently made tutor to the Princes of Saxony as a commissioned officer. From January 1916 until March 1917, assistant staff member at the Ministry for Public Works in Bremen; in March 1917, assistant lecturer in the Stieda chair at the University of Leipzig. On 4 May 1918 post-doctoral lecturing qualification at the University of Leipzig under Karl Bücher; in January 1920, associate professor of Economics at the University of Rostock; in 1920, professorship in Economics at the University of Kiel; in 1924 at the University of Cologne; from 1937 professor of Economics and Political Sciences at the University of Bonn until his retirement from academic service in 1957. From 1931 to 1939, he was German director of the German-Italian Cultural Institute (Petrarca-Haus) in Cologne.

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Norbert Kloten

**Böhm, Franz**

Born 16 February 1895

Died 26 November 1977



*Böhm's influence on the development of anti-trust law and competitive policy in the Federal Republic as well as in today's European Union was considerable. With his academic work, he paved the way for the introduction of a law against trade restrictions; a law that makes it possible to take action against price cartels, predatory competition or the creation of monopolies through company mergers.*

During the 1920s and through tangible successes after the Second World War, Böhm made his conclusion public that economic →*competition* as a fundamental element of a →*market economy* requires a legal framework. His conclusion was frankly opposed to the currently prevailing views on which aspects of an economy needed to be organised. Cartels and business conglomerates were seen as an inevitable phenomenon of a late capital-

ist economy. However, and in large measure due to Böhm, even politicians had to concede that competition left to its own devices eventually self-destructs, unless restraints on competition are made illegal.

In Germany, this led to the internationally recognised, highly advanced →*Act Against Restraints of Competition*, which even left its mark on the continued development of the Competition Laws of the European Community. It forms the basis for action by the →*Federal Cartel Office* and the European Commission against agreements and mergers which restrict trade. Anyone who feels they have a case can defend themselves against improper use of economic power by appealing to the courts.

Today, the Act Against Restraints of Competition – often simply referred to as the antitrust law – has become a fully integrated part of the economic and social order.

Franz Böhm initiated this process with his most important work, *Competition and the Battle against Monopolies*, which was published in 1933. The Freiburg School where Böhm and Walter →*Eucken* had a guiding influence, started at around the same time. It represents one specific branch of the School of Ordo →*liberalism*, a legal system of liberties which, too, imposes boundaries on state interventions. As a Member of Parliament, Böhm was involved in the creation of the antitrust law that came into force in 1958.

ACADEMIC AND PROFESSIONAL CAREER: Professor Dr. jur. doctorate and post-doctoral lecturing qualification in Law; senior university lecturer at Freiburg in 1933, lec-

turer at the University of Jena until the withdrawal of his lecturer's licence on political grounds in 1938. 1946–1962: incumbent of the chair for Civil, Commercial and Economic Law in Frankfurt. 1952–1964: served a member of parliament for the Christian Democratic Union and led the German Delegation which negotiated reparation agreements with the state of Israel and the Jewish international associations.

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Ulrich Immenga

### Briefs, Goetz A.

Born 1 January 1889

Died 16 May 1974

*Thanks to his unusual academic and analytical ability, Briefs became known for his ruthless pronouncements on the structural weaknesses of the industrialised nations. He was not just an economist but also had a profound understanding of economic history. Moreover, Briefs was firmly anchored in a Christian view of 'Man and Society'.*

While initially Briefs stressed the positive role of the trade unions in terms of their social subjugation of capitalism, after the Second World War he became increasingly critical of them. Considering the fact that they had been set up as protective organisations for the

worker in a liberal-capitalist age, Briefs saw the transition from the 'classical' to the 'consolidated' trade unions as a problem in that they were trying to gain and exercise control over companies and the workforce.

Briefs was a proponent of the social market economy, which he saw as being under threat by the demands for 'parity in  $\rightarrow$ co-determination' and the 'democratisation' of the economy and all other aspects of society.

## ACADEMIC AND PROFESSIONAL CAREER:

Briefs initially embarked on undergraduate studies of Philosophy and History in Munich, but then changed to Economics in Freiburg, where he submitted his doctoral thesis on the spirits monopoly. After a brief stay in England, Briefs gained his qualification as a university lecturer in 1913 with a dissertation on the profit rate in Classical Economics. In 1919, Briefs took up a lecturing position at the University of Freiburg. There, the witty humanist and devout Christian wrote a critical appraisal of Oswald Spengler's book *The Decline of the Western World*. This is where he developed the category of the 'moral limit', arguing that under competitive pressure unscrupulous outsiders may sacrifice the ethical minimum and that this might be copied by all the economic players. In 1921 he accepted an academic position in Würzburg, only to return to Freiburg in 1923 where he composed his first long essay on labour issues, 'The Industrial Proletariat'. Having been one of the creators of the Regulations for Works Councils in 1920, Briefs was called to Berlin in 1926 where he set up the Institute for Business Sociology and Social Business Studies. He produced numerous publications on trade union issues and business sociology, critiques of the capitalist class system as well as essays on social ethics. In 1930 Briefs became a member of the Königswinter Circle, which laid the groundwork

for the encyclical *Quadragesimo Anno* (1931). In 1934, Briefs managed to flee to the United States where he became familiar with American developments, including the teachings of Keynes and the work of J. A. Schumpeter. Following his stay as a visiting professor at the Catholic University of America, Briefs accepted a position at Georgetown University. In 1960, he received an honorary doctorate for political science from the University of Munich. For his 80th birthday, Briefs's pupils, friends and colleagues presented him with a commemorative publication.

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Anton Rauscher

**Dietze, Constantin von**

Born 9 August 1891  
Died 18 March 1973

*A full appreciation of the significance of Constantin von Dietze for the emergence and development of the social market economy is impossible if only his (however important) theoretical articles on economics and particularly on modern agricultural economics are taken into account. Von Dietze had a much more lasting influence on the economic order*

*of post-war Germany, primarily through his public work and commitment to a social and economic life on the basis of his Christian Protestant faith.*

Due to his staunch character, von Dietze was opposed to Hitler's regime early on. As chairman of the Association for Social Policy – the most important association of economists in Germany – von Dietze saved the association from national socialist interference by dissolving it in 1936.

He was briefly arrested for the first time in 1937 while standing in for an imprisoned pastor in a church service. After this incident von Dietze had to leave the University of Berlin. He took a position at the Faculty of Law and Political Science in Freiburg. There he exchanged ideas with the 'founding fathers' of the Freiburg School and the ordo-liberalism of Walter →Eucken.

The dissident Bonhoeffer Circle in Freiburg, of which he was a co-founder, had been asked by the provisional leaders of the Confessional Church to write a memorandum on post-war Germany. Together with Walter Eucken and Adolf Lampe, von Dietze compiled *The Economic and Social Order*, which contains passages that resemble an early manifesto of the →social market economy. After the attempt to assassinate Hitler on 20 July 1944, some parts of the memorandum fell into the hands of the Gestapo and von Dietze was arrested again. He escaped a certain death sentence thanks to the collapse of the Third Reich.

After the war, von Dietze, together with other members of the Freiburg Circle, was behind the foundation of the inter-denominational and decidedly

market-orientated Christian Social People's Party of Baden, which was subsequently incorporated into the Christian Democratic Union.

Beyond that, von Dietze was a dedicated academic and rector at the University of Freiburg (1946–1949). He was also a leading member of the Protestant Church and was involved in the establishment of the Federal Republic of Germany, always aware that 'every economic order must be based on specific political and moral principles'.

ACADEMIC CAREER: 1909–1912 undergraduate studies in Law and Political Sciences at Cambridge, Tübingen and Halle. 1913–1918 active service and captivity. 1919 Doctorate at the University of Breslau. 1922 Post-doctoral lecturing qualification at the University of Berlin. 1925–1961 professorships at the universities of Rostock (1925–1927), Jena (1927–1933), Berlin (1933–1937) and Freiburg (1937–1961). 1955–1961 presiding member of the Synod of the Protestant Church in Germany.

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DIETZE, C. v./EUCKEN, W./ LAMPE, A. (1942/1979), Wirtschafts- und Sozialordnung, in: *In der Stunde Null. Die Denkschrift des Freiburger 'Bonhoeffer-Kreises': Politische Gemeinschaftsordnung. Ein Versuch des christlichen Gewissens in den politischen Nöten unserer Zeit*, Tübingen, pp. 128–145; DIETZE, C. v. (1962), *Gedanken und Bekenntnisse eines Agrarpolitikers*, Göttingen; — (1967), *Grundzüge der Agrarpolitik*, Hamburg, Berlin.

Nils Goldschmidt

## Einaudi, Luigi

Born 24 March 1874

Died 30 October 1961

*Luigi Einaudi started publishing the magazine Riforma Sociale in 1908. After it was banned in 1935, he replaced it with the Rivista di storia economica, without compromising on the content but including more material on the integration of economic theory and history. It was there that Einaudi published his sensational endorsement of the book by Wilhelm →Röpke, The Social Crisis of the Present Day, which was subsequently banned in Germany. Like Röpke, Einaudi was an outspoken and thoughtful proponent of a competitive →market economy that favours neither private monopolies nor state control, and where political cronyism has no place. Einaudi advocated the accumulation of assets through savings and considered the taxation of saved income as well as the resulting proceeds as double taxation. His concept of consumer taxation had a modern ring to it. In terms of social policy, Einaudi supported individual responsibility and equal opportunities, and was in favour of private property for large sectors of society. He also wanted to preserve the peasant class in its traditional form as a counterbalance to the trend towards proletarianisation, for example, in anonymous tenement housing. As a liberal thinker with a broadly conceptual approach, Einaudi convincingly defended his view – in opposition to the philosopher Benedetto Croce – that intellectual, moral and political freedom without economic freedom is impossible.*

In 1928, Einaudi and others voted against the fascist government in Italy's Senate, and in 1935 he opposed the unconditional approval of the war with Ethiopia. Einaudi wanted to see Europe politically united in a defence alliance.



He contested the financing of budget deficits and bread subsidies by the central bank and succeeded in putting the national budget back on an even keel. Einaudi also achieved the stabilisation of the lira at the current level of inflation without monetary reform.

Similarly to Jacques →*Rueff*, Ludwig →*Erhard* and Reinhard →*Kamitz*, Einaudi was able, as a neo-liberal professor, to put his theories into practice with great success. Together with Konrad Adenauer and Shigeru Yoshida, Einaudi was one of the great old men who, with determination and calm, initiated the reconstruction of their ruined countries after the Second World War.

ACADEMIC AND PROFESSIONAL CAREER: After his doctorate (1895), initially economics editor at the daily paper *Stampa*. 1902–1948 professor of Finance at the University of Turin and professor of Political Economics at the Technical College. In 1920, additional professorship at the Bacconi University in Milan. From 1925, forced to restrict his teaching activities to the University of Turin. Became a Senator of the Kingdom of Italy in 1919, and was appointed rector of the University of Turin in 1943 by a government that was no longer fascist. Managed to escape fascist persecution by fleeing across the Alps to Switzerland. 1945–1948 Governor of the Banca d'Italia, member of the Constituent Assembly, and from May 1947 Minister of Finance and Deputy Prime Minister. 1948–1955 Italian President. Involvement in the newspaper *Corriere della Sera* from 1900 followed by his withdrawal in 1925 as an act of protest against fascist control. 1908–1946 correspondent for *The Economist*.

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EINAUDI, L. (1958), *Saggi sul risparmio e l'imposta*, Torino; — (1964), *Lezioni di polit-*

*ica sociale*, Torino; BENEDETTO, C./EINAUDI, L. (1957), *Liberismo e Liberalismo*, Milano, Napoli.

Hans Willgerodt

**Engels, Wolfram**

Born 15 August 1933

Died 30 April 1995

*Engels was one of a number of economists who always advocated and defended the social market economy and its principles in their research, teaching and publications. He was also one of the few economists who knew that economics and business management are so closely linked as to be virtually one entity, and who continually demonstrated this through his extensive knowledge. This gave Engels added credibility when he had the courage to stand up for his beliefs during the 1968 student uprisings at the University of Frankfurt, opposing the Marxist spokesman with his sober arguments and upholding the principle of individual freedom and the advantages of the market economy over all the many permutations of collective or state-controlled economies.*

This phase was instrumental in turning Engels into a political economist in the spirit of →*liberalism*. He took it upon himself to support the development of the →*social market economy* and to protect it against genuine enemies and false friends. Studies like *On Civic Taxation* (1973, with J. Mietschke), on the integration of individual taxes with personal social transfers, his writings on wealth creation (1974), on the labour market and co-determination (1974 and 1978) as well as his essays concerning the social market economy (including *More*

*Market: Social Market Economy as Political Economy*, 1976; *Thirty Years of Social Market Economy Experienced But Not Understood*, 1979) and his writings on economic and social policy (*A Constructive Critique of the Welfare State*, 1979; *Die Wende: Taking Stock of German Economic Policy*, 1984) are testimony to this self-imposed task.

But this did not mean that Engels was neglecting his other major academic interest: banking and the monetary and financial markets. Having analysed them creatively and critically, he provided suggestions on how to stimulate the markets and →*competition*. In his capacity as editor of the weekly *Wirtschaftswoche*, Engels was able to give a wide audience access to his articulate and innovative ideas on institutional order policy.

ACADEMIC AND PROFESSIONAL CAREER: 1953–1955 management apprenticeship in Bremen; 1955–1961 undergraduate studies; 1961–1964 sales manager in the textile industry; doctorate in 1962; 1964–1968 assistant lecturer; 1968 postdoctoral lecturing qualification with W. →*Stützel*; 1968–1995 professor at the Johann Wolfgang Goethe University, Frankfurt; 1984–1987 editor of the *Wirtschaftswoche*; Awards: The Ludwig Erhard prize and others.

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ENGELS, W. (1970), *Soziale Marktwirtschaft als Politische Ökonomie*, Stuttgart; — (1996), *Der Kapitalismus und seine Krisen. Über Papiergeld und das Elend der Finanzmärkte*, Düsseldorf.

Rolf H. Hasse

## Erhard, Ludwig Wilhelm

Born 4 February 1897

Died 5 May 1977



*Erhard made a significant contribution to the restructuring of the German economic system and to the birth of the 'economic miracle'. It was he who popularised the term →social market economy in Germany. His aim was 'prosperity for all' in a free society. As Federal Chancellor, Erhard tried to encourage the socio-political acceptance of the social market economy. It was his hope that more understanding of and information on economic issues would be able to prevent institutional order policy aberrations. This is why he established a →Council of Experts who were appointed to monitor overall economic progress. His concept of a 'formed society' – where particular group interests are overcome through cooperation and competitive pressure – remained utopian.*

Even before the end of the war, Erhard had composed a memorandum that emphasised the need for currency

reform. In 1947, he was made director of the Homburg Special Bureau for Monetary and Currency Matters. Based on different reform drafts by German experts, the bureau submitted the Homburg Plan for German currency reform. Elements of this plan were adopted by the Allies in the currency reform that took place in the three Western zones on 20 June 1948.

From March 1948, Erhard, who was economic director of the bizonie, was faced with the task of complementing the currency reform with an appropriate economic reform. Germany was at that time subject to an all-encompassing system of government price controls and regulations on economic management.

Concurrently, with the replacement of the Reichsmark by the Deutschmark, Erhard decided to initiate the complete removal of state control and to rely on the effectiveness of the free markets.

However, Erhard was aware of the fact that without a stable new currency it would not be possible to revert to a free market economy. Only an efficient market economy would be able to demonstrate its extraordinary capacity to satisfy material needs to the full, win lasting acceptance by the people and become a genuine social market economy.

The sharp productivity increase and the visible reduction of goods shortages after the currency reform endorsed Erhard's market-orientated economic policy, which he continued to pursue as Federal Minister of Economic Affairs.

From very early on, Erhard favoured a far-reaching liberalisation of foreign trade in order to see Germany becoming more deeply rooted in the world economy (→*foreign trade*). It is thanks to his sustained efforts that the

principles of the market economy were taken into account in the process of European economic integration.

On the occasion of the currency reform Erhard had already suggested the urgency of an effective German antitrust law being put in place. For him, anti-competitive company agreements and inflation remained the two greatest threats to a successful social market economy. When the →*Act Against Restraints of Competition* was finally passed in 1957, Erhard had only partly succeeded. While it is true that the Act imposed a general ban on cartels, a long list of areas and issues were exempt from the rules.

In the same year, the Federal Banking Act declared the independence of the central bank (→*European Central Bank, German Federal Bank*) and its commitment to →*price level stability*. Erhard had been a keen supporter of both these key elements of the financial system.

ACADEMIC AND PROFESSIONAL CAREER: 1919–1922 studies at the College of Commerce in Nuremberg; 1925 doctorate in Frankfurt; 1928–1942 economic research at an institute in Nürnberg; 1945–1946 Bavarian Minister of Economic Affairs; 1947 honorary professorship at the University of Munich; 1947–1948 director of the Special Bureau for Monetary and Currency Matters in Bad Homburg; 1948–1949 administrative director of Economic Affairs in the British-American bizonie; 1949–1977 Member of the German Parliament; 1949–1963 Federal Minister of Economic Affairs; 1963–1966 Federal Chancellor; 1966–1967 Chief Whip of the Christian Democratic Union.

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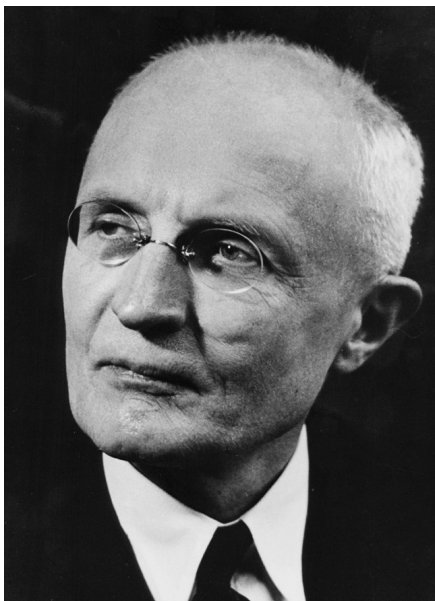
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Rainer Klump

### Eucken, Walter Kurt Heinrich

Born 17 January 1891

Died 20 March 1950



*'How can the modern industrialised economy be integrated into a system which is both effective and humane?' Walter Eucken asked himself this question, which animates his life's work. His answer was the development of the concepts which Ludwig →Erhard implemented, and which led to the German economic miracle after the Second World War.*

*Eucken saw power – of a private as well as a public nature – as a central problem in modern economic systems and demanded that, in order to restrain it, the state should adopt institutional order policies which adhere to the principle of competition, and that there must be no interference with the economic process.*

Eucken's insights were strongly influenced by personal observations dating back to the time before and after the First World War.

Before 1914, governments used to follow the classical liberal principle of laissez-faire: the state simply provides a legal framework and otherwise leaves the economy to its own devices. This policy was based on the individual's right to freedom. The consequence, however, was that monopolies and cartels started to dominate many sectors of the economy because economic actors considered competition to be a nuisance and a threat to their attempt to monopolise. This is how private power blocs come about. Eucken saw this as a serious obstacle to the right to freedom of others. During the era of laissez-faire, the abundance of freedom turned into a threat to freedom itself, because it allowed private power build-ups.

After the First World War, economic policy changed fundamentally and became the opposite of what it had been. The state started to intervene in the economy more and more and tried to exercise control through policies aimed at preventing →business cycles, →... monetary policy, →subsidies, etc. depending on the specific situation. This meant that now the state had a great deal of power at its disposal.

In this, Eucken recognised the hallmark of centrally controlled economies

(→*socialism*, →*constructivism*, →*third ways*). The problem of power as a restriction to freedom had therefore not been solved, but only displaced.

Beyond that, there is another consequence of interventionist economic policy. An economic policy which deals with individual cases on their own merit will always affect everybody differently. Certain groups will benefit while others will be disadvantaged. This is the motivation for the formation of private →*interest groups* whose purpose is to fight for economic policies which benefit their members. The members then exploit the privileges granted by the state to secure more privileges for themselves. This is how the state is put under pressure by these groups and eventually becomes dependent on them (→*interventionism*).

Thus interventionist economic policies lead to a dual power problem: while expanding its power through various interventions into routine economic processes, the state comes increasingly under the influence of powerful economic groups.

In the modern economy, therefore, personal freedom is equally under threat from public and private power. It is widely believed that the problem of private economic power can be solved only if the state seizes it. However, this cannot be the solution as far as individual freedom is concerned. According to Eucken, the problem of economic power can never be solved through further concentration of power. The fact is that, on the contrary, the freedom of the individual must be safeguarded with respect to the other citizens and to the state.

In the light of this dilemma, what

should an economic policy look like? In other words, how can the modern industrialised economy be integrated into a system which is both functional and humane? In answer to this question, Eucken developed his famous concept of →*institutional order policy* (*Ordnungspolitik*).

Institutional order policy is the kind of economic policy which forms the content of an economic system. Opposed to institutional order policy is →*process policy*. The latter concerns those economic policy measures which politicians use to intervene in the actual economic process, and which affect the way it runs either directly or indirectly.

The fundamentally disparate nature of these two categories of economic policy showed Eucken the dividing line between legitimate and necessary economic policy on the one hand, and illegitimate economic policy on the other. Economic policy should give content to the economic order without influencing the economic process.

A great many different economic systems are, in theory, possible. Eucken identified three basic types: the centrally controlled economy; an economic system based on monopolies; and a competitive system. He devoted much time to studying the centrally controlled economy and subjected it to a thorough critical analysis. There is no need for further elaboration on this point because the matter of the centrally administered economy was famously settled after the events of 1989.

Economic structures based on monopolies are characterised by the fact that the individual goods and job markets are dominated by monopolies or

similar structures such as cartels. It, too, was rejected by Eucken for the aforementioned reasons.

What remained was the competitive order. For Eucken, this was the economic structure that allowed for the highest degree of personal freedom as it restricts the powers of the state (unlike the centrally controlled economy) and (unlike the monopolistic economy) also curbs private power.

→*Competition* – where suppliers compete for the favour of buyers, while buyers compete for the favour of suppliers – is the one process that does not allow power reservoirs that are prone to abuse to build-up. This is because in a competitive system the actors in the markets can always choose from several business partners.

As the *laissez-faire* model before the First World War showed, a competitive economic order does not emerge by itself. So what should the state do to establish and maintain it? In other words: which institutional order policy should be adopted? Eucken identified seven conditions which have to be fulfilled for the creation of a resilient competitive order.

The first and most important condition is a market structure based on a sound pricing system, which must be a realistic reflection of relative scarcity combined with a high degree of competitive pressure. The competitive pressure increases with the number of suppliers and buyers who are active in the market. This makes a general ban on cartels and monopolies the necessary consequence. The other six conditions can only be listed here:

- a stable currency;
- freedom of market entry (→*open markets*), which involves the removal of both public and private economic barriers to market entry;
- →*private property*;
- freedom to enter into contracts;
- →*individual responsibility* and the liability of each economic participant for his/her own economic actions; and
- a consistent, steady economic policy in order to avoid uncertainty.

Eucken was also deeply concerned with social issues, which helped him form his conclusions. He made it unmistakably clear that no economic order would survive for long unless these social aspects were taken into consideration. He believed, for example, that a social conscience cannot tolerate mass unemployment – and nor can the state.

However, Eucken was very critical of the traditional →*social policy* because it interferes with the right to personal freedom by forcing everybody into state insurance schemes. In Eucken's view, this incapacitates the individual by making the citizen increasingly dependent on the state. Eucken saw this as almost a sort of enslavement by the state and, as a consequence of the denial of basic human rights, the destruction of what makes us human.

This is why, according to Eucken, if social policy is to be successful there has to be an institutional order policy at the same time. And the problem of mass unemployment can be solved only if the principles of competition also find

application in the labour market. Trade unions and employers' associations would then not be able to behave like monopolies and negotiate binding wage agreements, but wage levels would be decided freely by the market.

Regarding social security, Eucken wanted to lean much more on the private initiative of the individual: the political system was giving the citizens every opportunity to secure themselves. In Eucken's view, a public welfare system was only justified when self-help and insurance did not suffice; but, whenever possible, the free initiative of the individual had preference.

ACADEMIC AND PROFESSIONAL CAREER: 1909–1913 undergraduate studies in Kiel, Bonn and Jena, 1913 doctorate in Bonn; 1913–1918 military service; 1919–1925 University of Berlin, 1921 post-doctoral lecturing qualification, then assistant professor; 1925–1927 professorship in Tübingen; 1927–1950 professorship in Freiburg.

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Lüder Gerken

**Frickhöffer, Wolfgang**

Born 26 May 1921

Died 31 October 1991

*Frickhöffer was generally known as the 'watchdog of the social market economy' and was a man who was equally merciless towards the declared enemies of the →social market economy and those who pretended*

*to be its fervent supporters but thought nothing of betraying their conviction when things became difficult. For Frickhöffer, the social market economy was no fair weather system, but a concept for all seasons.*

Frickhöffer had to contend with all the vicissitudes of the war and the post-war period. Immediately after graduating from the Berlin-Steglitz Gymnasium with a classical education, he was called up for compulsory labour and military service and ended up in captivity. After the war, he supported himself with various jobs: he was a part-time journalist (1949–1952); became a certified interpreter (1951–1954); and studied economics at the University of Heidelberg. Alexander →Rüstow, who, after his return from Turkey had succeeded to Alfred Weber's chair at the University of Heidelberg, was his most influential teacher.

In January 1954, Frickhöffer accepted the position that would become the core of his life's work: he became secretary of the Social Market Economy Action Group (*Aktionsgemeinschaft Soziale Marktwirtschaft* – ASM). After the death of Alexander Rüstow, Frickhöffer's academic mentor and previous chairman of the ASM, Frickhöffer became his successor in 1962.

The ASM provided Ludwig →Erhard with staunchly supportive publicity for his reconstruction and reform policies. It was here that the guardians of the doctrine of the social market economy found a platform for their ideas and concepts and took on the role of political opinion-makers.

The →Act Against Restraints of Competition, the autonomy of the →German Federal Bank and the organi-

sation of the European Community were topics under intense discussion at these meetings, while repeated, fervent debates about currency revaluations and the floating of the exchange rate were also on the agenda.

Karl →Schiller, the Minister of Economic Affairs, delivered lectures on social symmetry and the recovery process after an economic slump. In short, the ASM was, and still is, a place where the future course of the market economy is considered and where clear pointers are put in place.

Although Frickhöffer always ensured that this remained the case, he did not simply offer to the architects of the social market economy a highly respected platform; instead, he actually initiated and encouraged national and international debate – not least through the Mont Pèlerin Society.

At the same time he was not afraid to make public and private statements on the current political situation from the perspective of the market economy. He could be very blunt when he suspected or was able to prove bungling, disimprovements or institutional order policy breaches.

The former Federal Minister of Economic Affairs, Otto Count Lambsdorff, paid tribute to Frickhöffer for playing the role of the admonishing voice and for his commitment to the cause of the *res publica* by saying: 'It is Wolfgang Frickhöffer's great contribution to have been able, with penetrating knowledge and without having to make allowances for the political conventions of the day, to lay his finger on the wounds which keep being inflicted on the market economy. His advice and his comments are a wake-up call for politi-

cians and his nagging is not always comfortable, but he is fighting a just fight.'

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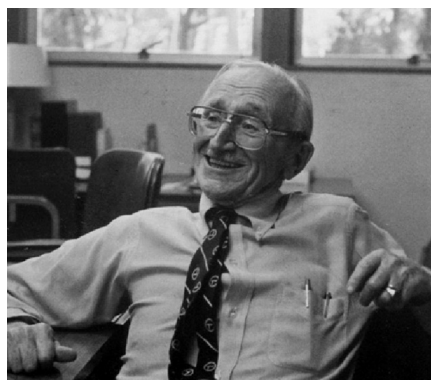
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Joachim Starbatty

### Hayek, Friedrich August von

Born 8 May 1899

Died 23 March 1992



Hayek is seen as one of the most important representatives of 'neo-liberalism' of the war generation. In 1974 he was awarded the Nobel Prize for his comprehensive work on economics and social philosophy. As a liberal of the classical tradition he was one of the foremost critics of socialism and the welfare state, while also being a fearless supporter of a free



*society. Hayek was intellectually close to the 'founding fathers' of the social market economy, especially Wilhelm →Röpke, Walter →Eucken and Ludwig →Erhard. It is true that he strongly criticised the term 'social' for being too vague.*

Hayek's comprehensive body of work grew out of a critical analysis of the 'constructivist', planned or centrally controlled economy typical of the totalitarian systems. He proved that socialism is not only doomed to failure because enterprises cannot make economic calculations without scarcity-related prices, as his teacher Ludwig von Mises had discovered, but also for reasons concerned with information theory. He called it a 'presumption of knowledge' to want to centrally store all the knowledge, which is so dispersed among people and places, which is ever-changing, and which has accumulated throughout history and endless experience.

Hayek's detailed theory of 'spontaneous order' draws especially freely on the ideas of the 18th century Scottish order theorists (Ferguson, Smith, Hume). He showed convincingly that a spontaneous, complex economic system is the result of human action but not of rational design. The market, morality, the law or language were not 'invented' by anyone in particular; rather, these institutions developed in a historical process of trial and error where only those groups succeeded who 'discovered', above all, private →*property* and the appropriate moral rules.

Hayek became particularly famous for his contribution to the theory of competition: →*competition* is 'a process

leading to the discovery of facts which would otherwise either remain unknown or would at least not be utilised'.

Although Hayek was one of the harshest critics of the →*welfare state* and had even laid out propositions for the 'denationalisation of currencies', he cannot be seen as a typical representative of the 'laissez-faire tradition'. Rather he was an excellent analyst of the institutional framework (albeit not predominantly of the state), which requires a spontaneous order.

Furthermore – to the annoyance of some of his friends – Hayek supported the concept of basic social security, but not through a monopolistic state insurance scheme. Nonetheless he was one of the most outspoken champions of a free society.

During his later years, Hayek drew up a political reform plan for democratic systems, which has hitherto not aroused much interest. His primary concern here was to reinstate the separation of powers through a bicameral system where one chamber, made up of economically independent representatives of different age groups, has the task of ensuring that the executive observes the general, abstract rules without giving specific pressure groups an unfair advantage.

Hayek's influence has been growing steadily since the 1970s. His impact on Ronald Regan's reforms in the United States and on Margaret Thatcher in the United Kingdom was considerable. The Friedrich August von Hayek Society in Berlin, founded in 1998, is currently involved in the publication of his German works and the organisation of public events.

ACADEMIC CAREER: Undergraduate studies in Law and Political Sciences at the University of Vienna; 1929 post-doctoral lecturing qualification in Vienna. From the end of 1931 onwards a professorship at the London School of Economics; 1947 co-founder of the Mont Pèlerin Society; 1950 professor of Social and Moral Sciences at the University of Chicago; 1962 accepts a position at Freiburg; 1968–1977 visiting professor at the University of Salzburg; 1974 Nobel Prize for Economic Sciences together with Gunnar Myrdal; 1991 the Presidential Medal of Freedom from the United States President.

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HAYEK, F. A. von (2003), *Der Weg zur Knechtschaft*, 3rd edition, Munich; — (1991), *Die Verfassung der Freiheit*, 3rd edition, Tübingen; HABERMANN, G. (ed) (2001), *Philosophie der Freiheit. Ein Friedrich-August-von-Hayek-Brevier*, 3rd edition, Thun; HENNECKE, H. J. (2000), *Friedrich August von Hayek: die Tradition der Freiheit*, Düsseldorf.

Gerd Habermann

**Hensel, K. Paul**

Born 24 January 1907

Died 20 April 1975

→Eucken, *Hensel's teacher, had recognised the interdependence of the individual elements of a social system. On this basis, Hensel made the analysis of the economic and social systems of the previously 'socialist' countries (primarily the former German Democratic Republic and Eastern Europe) with their dictatorial, centrally administered economies, the focal point of the research programme which was linked to his academic post. He was also in charge of the Institute for Comparative Economic Systems, where such systems were*

*compared with the market economies of democratic systems. No other institute, except perhaps the Eastern European Institute at the Free University of Berlin, produced as many dissertations, theses and postdoctoral theses on this subject as Hensel's research centre in Marburg. Until the end of his life, Hensel had a considerable impact on this branch of economic research.*

Even before coming under the influence of his academic teacher Walter Eucken (the founder of the Freiburg School of Economics, which dealt with questions of institutional order theory and policy), Hensel's experiences during his vocational training before he was a student had awakened a particular academic interest in him in the intellectual approach to 'socialist' and 'capitalist' economic systems, the way they function and the effect they have on people.

This problem mattered not only for abstract, theoretical reasons, but it kept the world in suspense for decades while playing a crucial role in the fate of millions of people (→socialism/planned economy).

Economic theory was grappling with a controversy dating back to the beginning of the previous century, but started to deepen during the 1930s: the question was whether a 'socialist' economy based on centrally planned economic processes and collectively owned material means of production could accommodate rational and conclusive 'economic calculations' similar to those familiar with the different forms of the market economy.

These calculations ensure that the factors of production (labour, land, capital) that are always scarce and in limit-

ed supply, are allocated in such a way that they are utilised in a macroeconomically sensible and thus correct manner (→market economy).

In his 1954 postdoctoral thesis, Hensel contradicted Eucken in his conclusion that the abstract model of a centrally controlled economy could indeed contain such a 'calculation mechanism'. He was, of course, aware of the fact that real life socialist economies no more lived up to such a model than the actual market economies lived up to the very abstract theoretical model of an economy of 'total competition'. Hensel was and remained extremely sceptical regarding the possibility of realising a genuinely effective centrally administered economic order, and he was clearly vindicated in this by the collapse of the economic and social systems of 'socialist' states later on.

ACADEMIC AND PROFESSIONAL CAREER: 1925 trained and qualified as a carpenter. 1931 successful completion of an exam for the academically gifted followed by an undergraduate degree in economics in Berlin and Freiburg. 1937 submission of his doctoral thesis followed by studies at the London School of Economics. 1951 post-doctoral lecturing qualification in Freiburg. 1957 accepts the Chair of Economics at the University of Marburg. 1963–1964 dean of the Faculty of Law and Political Science at the University of Marburg, and 1965–1967 rector of that university.

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Gernot Gutmann

**Höffner, Joseph Kardinal**

Born 24 December 1906

Died 16 October 1987

*More than anyone else, Höffner embodied the church's transition from social romanticism involving the utter rejection of the modern way of living and working in an industrialised society on moral grounds, to social reform and active participation in economic organisation in terms of 'institutional order policy'. Höffner was undoubtedly the most influential representative of Christian social doctrine: under his guidance, it flourished as an academic discipline in a way that was unmatched either before or after. Höffner stressed the ethical significance of social institutions, saying that: 'History teaches that freedom and human dignity largely depend upon the organisation of the economy.' He was a respected political adviser and made a significant contribution to the idea of subsidiarity anchored in the structure of the labour and social systems of the German Federal Republic, while as an academic teacher he guided a whole generation of future decision-makers.*

Sometimes a person has so many abilities and talents that even a good 80 years are not enough to express them to the fullest. This definitely applies to Joseph Höffner, who was born the son of a Westerwald farmer on Christmas Eve of 1906. He had five sisters and, after the premature death of his mother, two step-brothers. During his life, Höffner managed to play a number of different roles in quick succession, and in each

phase he achieved the sort of ‘excellence’ that is much talked about nowadays but for which many lack the necessary self-discipline and inner strength. It cannot have been easy for the father to give up his eldest to an academic career; having been prepared for senior school by the local priest, the bishop saw to it that he was sent to the Gregoriana Papal University to study theology right after receiving his school-leaving certificate in 1926.

### ***Höffner the academic***

In the years between 1929 and 1941, Höffner collected no fewer than five doctorates. He lived in Rome until 1934 (theology, canon law, philosophy), then in Saarbrücken after his time as a curate, and then in Freiburg (theology, economics). It may seem uncanny that while the Second World War was turning Europe to ashes all around him, Höffner followed his economics degree (graduation 1939) with a doctorate under the reputable economist Walter →*Eucken*, one of the architects of the social market economy. Höffner’s thesis dealt with ‘Economic ethics and monopolies in the fifteenth and sixteenth centuries’. But the young Höffner certainly did not hide from the horrors of his time in the ivory tower of academic pursuits. The fact that he was able to bridge the academic gap between historic and systematic research was a rare feat. It was also proof that those who believed that devotional Christianity and the modern world were fundamentally incompatible, were mistaken.

In his field, Höffner prepared the ground for a successful new start for a post-war Germany by getting the Church to acknowledge the ideas

behind the social market economy. He was later actively involved in its official acceptance.

### ***Höffner the priest***

Even as a distinguished academic and lecturer with his many doctorates, Höffner – true to the tradition of Christian social doctrine – did not feel that pastoral work was beneath him. From 1943–1945 he was the priest in charge of the working-class parish of the Holy Cross in Trier. As a young curate in Saarbrücken, he decided to commit himself to lifelong abstinence out of solidarity with a group of alcoholics. From March 1943 onwards Höffner kept Esther Sara Meyerowitz, a seven-year-old Jewish girl, in hiding under the assumed name ‘Christa Koch’. This was an offence in the National Socialist state that, if discovered, would certainly have had fatal consequences for a clergyman like himself.

### ***Höffner, the professor of Christian social doctrine***

Höffner had to wait until the regime of terror had ended before he could become a professor – first at the seminary in Trier, and from 1951 as incumbent of the renowned chair of Christian Social Sciences in Münster.

His time in Münster, which spanned just over a decade, was of particular importance in terms of his impact on the →*social market economy*. Prepared through his research (together with contemporary teachers such as the Jesuit Oswald von →*Nell-Breuning* in Frankfurt and Johannes Messner in Vienna), Höffner helped the Catholic Church in Germany to overcome its hostile attitude towards the modern

economy and society, which had contributed to its refusal to acknowledge the Weimar Republic and consequently to the totalitarian aberrations of the 20th century. Among other things, Höffner was an academic adviser to the Catholic Employers' Federation, a national association that received crucial input from him.

### **Höffner, the church leader**

Höffner became Bishop of Münster in 1962, Archbishop of Cologne in 1969 and a member of the College of Cardinals as well as president of the German Bishops' Conference from 1976 until shortly before his death in 1987. Here, too, he was building bridges between the Church and the modern economy and society: at the second Vatican Council, he helped to forge the groundbreaking methodical re-orientation of the Church in the Council documents (particularly in the pastoral constitution *Gaudium et Spes*), in such a way that economics and the social sciences are basically granted autonomy.

In the worldwide organisation of the Catholic Church, too, Höffner was working towards a Christian social doctrine that was open to the secular world. Numerous honorary doctorates from Asian and Latin American universities reflect this involvement. Some 2.8 million copies of his book have been published and it has been translated into 12 languages.

International honours include the Orders of Merit from the Federal Republic of Germany and the Republic of Italy. Another major achievement was his contribution to the financial consolidation of the previously seriously indebted Vatican State.

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*André Habisch*

### **Kamitz, Reinhard**

Born 18 June 1907

Died 9 August 1993

*More than anyone else, it was Kamitz who introduced the concept and the principles of the 'social market economy' in Austria after 1945. He began while he was in charge of the Economic Policy Department of the Federal Chamber of Trade and Commerce (1946-1951), and even more forcefully as Finance Minister (1952-1960) and as President of the Austrian National Bank (1960-1968). Taking such a clear stand regarding order policy required considerable courage since the economic policy programmes of the two large parties, the Österreichische Volkspartei (ÖVP) and the Sozialistische Partei Österreichs (SPÖ), were both greatly at variance with those of the social market economy: the ÖVP in the direction of Christian social and class-related ideas, and the SPÖ in its tendency towards socialist central planning concepts (Austromarxism).*

Kamitz's own stance was based on a combination of the main principles of the social market economy and ordoliberalism (→liberalism), adapted to

Austrian conditions. The economic policy contributions by Kamitz had the effect of clarifying the politically confusing concepts about the 'social market economy' to the extent that from the time when Julius Raab became Federal Chancellor and Kamitz became Minister of Finance, the emerging economic and social order in Austria was referred to as a 'social market economy'.

Kamitz believed in the 'interdependence of the systems' (W. →*Eucken*). He also believed that in economics, political and cultural liberty are indispensable. Kamitz brought about the independence of the Austrian Central Bank in 1955 and made sure that the stability of the currency was its supreme goal; furthermore, the funding of any sort of national organisation was prohibited thanks to his efforts. Both goals were also incorporated into the Treaty of Maastricht in 1992 (→*European Economic and Monetary Union*) with regard to the European Central Bank. Through a number of tax reductions which were spectacular at the time, he then succeeded in showing that such steps can increase state revenue and can act as an incentive for performance and investments.

Kamitz had already advocated the adoption of these principles during the negotiations on international and monetary relations. For the stabilisation of price levels he considered a competitive policy which is implemented by the government but extends beyond national borders as the best option – more effective than wage and price agreements between unions and management, and also more effective than official price control. Kamitz wholeheartedly agreed with the opening of

the national borders through the gradual liberalisation of the former Organisation for European Economic Cooperation, which led to the removal of quantitative trade restrictions for goods and services. He also approved of the regulations of the International Monetary Fund for the lifting of all exchange restrictions in favour of the Austrian schilling and the agreements in the General Agreement on Tariffs and Trade for the gradual removal of customs barriers. For these reasons, Kamitz wanted to see Austria as an active participant in the fledgling European economic integration, because he was sceptical about whether a social market economy with the necessary economic policy consistency could be implemented politically in Austria.

Kamitz felt that it would be uneconomical to fight anti-competitive agreements in isolation in the small Austrian market. He therefore advocated the expansion of regional →*competition* and the liberalisation of the movement of goods and services, as well as monetary and capital exchange.

ACADEMIC AND PROFESSIONAL CAREER: 1934–1939 Institute for Market Research, Vienna; 1938 professor at the World Trade College, Vienna; 1939–1946 Chamber of Commerce Vienna; 1946–1951 Federal Chamber of Commercial Economy, director of the Department of Economic Policy, deputy secretary general; 1952–1960 Federal Minister of Finance; 1960–1968 President of the Austrian central bank.

*Wolfgang Schmitz*

**Karrenberg, Friedrich**

Born 1904

Died 1966

*Karrenberg's significance does not primarily derive from a personal contribution to economic theory or even from a theological interpretation of economic ethics; it rather came from his active involvement as a mediator between church, society and the economy. As a theological layman, entrepreneur and scientist he contributed in a variety of ways to attract understanding for the →market economy in church circles. At the same time he proposed that the economy must be committed to the common good and show social responsibility. Karrenberg's powers of persuasion went beyond religious denominations, party politics and specific belief systems. Already in his dissertation on 'Christianity, Capitalism and Socialism' in 1933, he took a determined stand against the conservative Lutheran worship of the state. This – together with the equally important affirmation of individual liberty in Christian responsibility – forms a common bond between all the spiritual representatives of the →social market economy whose rootedness in the Christian human ideal has always been emphasised.*

ACADEMIC AND PROFESSIONAL CAREER: During the post-war era and the rebuilding of Germany, Karrenberg was an independent entrepreneur predominantly active in the Rhineland. He had numerous honorary posts in the Protestant Church, where his functions included that of a part-time member of the administrative body of the Protestant Church and where he acted as chairman of the Committee for Social and Ethical Questions of the Protestant Church in the Rhineland. He published significant socio-political statements during the 1940s and 1950s. He founded and was in charge of the Institute for Social Sciences in Velbert

(1965). In 1950–1961 he was chairman of the 'Work and the Economy' working committee in the German Protestant Church Congress; in 1954 he was charged with the publication of the *Protestant Social Encyclopaedia* (2001, 8th edition). During the final years of his life he was an honorary professor at the University of Cologne, where he focused on the history of social ethics.

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Martin Honecker

**Lutz, Friedrich August**

Born 29 December 1901

Died 4 October 1975

*When Lutz started his undergraduate studies in political economy in 1920, the Historical School was dominating the subject at the German universities. But it had nothing particular to offer in relation to the galloping currency depreciation of the post-war period. Lutz found that, like himself, the young assistant professor Walter →Eucken, was inclined to examine a problem theoretically in order to uncover its true causes and the underlying economic facts. The acquaintance with Eucken made a profound impression on Lutz. It was Eucken who made him leave his job to become an assistant in Freiburg and embark on an academic career. This is how Lutz gained access to the inner circle of the*

*ordo-liberal Freiburg School which was gathering around Eucken. Under National Socialist rule, when Lutz's career at German universities was blocked because of his liberal outlook, he emigrated to the United States, the country leading the way in contemporary theory. He returned to Europe soon after the Second World War.*

Lutz's dedication to research was legendary. His fields of research were interest theory, monetary theory and international currency systems. In the same way as for Eucken, his teacher, theories were never an end in itself for Lutz, but rather a means for an understanding of economic reality. A clear rational mind and the incorruptibility of its judgment earned him the respect of his academic colleagues. Instead of spoon-feeding his students, he trained them in getting to the bottom of a problem step-by-step. Lutz never came across as superior because he saw himself as someone who was always learning. This made him a genuine teacher who led by example.

Apart from its efforts to gain an understanding of the way an economy functions, the Freiburg School sought to work out the details of the economic and legal prerequisites of a competitive economy free of power blocs. Lutz was especially productive in the field of money and currency systems, where he acquired the reputation of being one of the top experts.

In numerous shorter essays he dealt with problems of his time: the collapse of the gold standard, the bank crisis of the early 1930s, the obstruction of the international goods and payment transactions through exchange controls, the balance of payments equilibrium of the post-war period and above all the ongo-

ing currency depreciation, whose ever-changing causes he managed to bring to light time and again. After an accurate analysis of the facts he always managed to get to the fundamental institutional order policy questions before working out proposed solutions.

Lutz was a leading proponent of the opinion that a competitive economy not only depends on the free international exchange of goods and capital, but that it will work properly in the long term only if the purchasing power of the currency remains stable. Lutz felt that it was wiser not to leave it to the whims of the politicians to look after the stability of the currency, but that the necessary regulations should be incorporated into the monetary and currency system.

Long before the international Bretton Woods post-war monetary system led to worldwide inflation and collapsed, Lutz had advocated flexible exchange rates. His view was that in a world prone to inflation, only flexible exchange rates make it possible for an individual country to commit its economic policy to the goal of *→price level stability*.

ACADEMIC AND PROFESSIONAL CAREER: 1920–1925 undergraduate and postgraduate studies of Economics and Political Sciences in Heidelberg, Berlin and Tübingen (Dr. rer. pol. – Doctor in Economics); 1926–1929 Association of German Mechanical Engineering Institutions in Berlin; 1929–1932 assistant to Prof. Walter Eucken in Freiburg; 1932–1938 assistant professor at the University of Freiburg; one year in England and one year in the United States on a Rockefeller Fellowship; 1938–1953 lecturing post at Princeton University (New Jersey), US, from 1947 as full professor;



1948–1952 visiting professor at the University of Freiburg; 1953–1972 professor at the University of Zurich.

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Verena Veit-Bachmann

**Meyer, Fritz W.**

Born 8 November 1907

Died 4 March 1980

*The Freiburg Circle had a formative influence on Meyer as an academic. His research was crucial for the development and consolidation of institutional order theory and provided a firm foundation for institutional order policy. As a disciple of Walter →Eucken, Meyer developed a burning interest in →institutional order policy which stayed with him throughout his academic career. The tangible result of this was a number of compelling investigations and analyses of the subject. They have repeatedly been made available in publications, giving lasting testimony to the lucidity of the language and the apt examples and explanations which characterise his style.*

Meyer was able to look back on a long and successful career at the University of Bonn, where he remained despite being offered many prestigious academic positions. He also turned down senior positions in government because he saw the danger that inevitable politi-

cal compromises might force him to deviate from his theoretical convictions. He rather saw it as his task to provide economic policy with useful concepts, and his participation in numerous advisory committees gave him the opportunity to do just that. It was the combination of his academic approach, where diagnosis and therapy were inseparably linked with the incorruptible clarity of his thinking, writing and arguing, that enabled him to come up with outstanding and at times pioneering insights.

The topics Meyer worked on cover a wide area, but he always reserved a particular interest for international trade relations, labour and development policies as well as currency problems. His notable publication on *The Reconciliation of the Balance of Payments*, which appeared in 1938, still offers a definitive analysis which cannot be ignored by anyone who is looking for a practically applicable theoretical background to balance of payments-related problems.

Beyond that, it was above all specific institutional order policy issues which challenged and fascinated him again and again. For Meyer, it was an important economic policy objective and a compelling task to clarify the basic structure of the market system, but also to examine the elements forming such an economy. In his investigations of pressing economic problems, Meyer was masterful in that he was able to reduce a problem down to fundamental economic principles and, at the same time, to show how it related to institutional order policy. In his critical analyses, he was as ruthless in uncovering cases of self-centred lobbying as he was with the stubborn tendency to →inter-

ventionism and restraints of competition, which he exposed with brilliant logic and wit as economically unfounded and unacceptable.

ACADEMIC AND PROFESSIONAL CAREER: Undergraduate studies in Economics; 1934 doctorate with Walter Eucken; 1934–1937 assistant at the Institute for World Economy in Kiel and with Eucken in Freiburg; 1938 post-doctoral degree with Eucken; 1938–1943 lecturer at the University of Kiel; 1946 assistant professor, 1948 full professor at the University of Bonn; 1950 member of the Scientific Advisory Council at the Federal Ministry of Economic Affairs; 1962–1965 member of the Council of Experts for the Investigation of Economic Development; 1973 professor emeritus.

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Helmut Gröner

### **Miksch, Leonhard**

Born 20 May 1901

Died 19 November 1950

*Ordo-liberalism and the Freiburg School are most closely associated with names like Walter →Eucken, Franz →Böhm and Alfred →Müller-Armack, who for good reason count among the most outspoken representatives of this particular variety of economic policy. It is unfortunate that in this context the*

*name Leonhard Miksch is frequently overlooked. His premature death notwithstanding, he made an important contribution to the rebuilding of the fledgling Federal Republic, both in his role as a university teacher and through his hands-on involvement in economic policy.*

In terms of his career development, Miksch differs substantially from his ordo-liberal fellow combatants. After initially studying chemistry, he changed to political economics and graduated in economics in Tübingen in 1926, completing his doctorate three years later. Walter Eucken, who remained a life-long friend, was his supervisor. But instead of embarking on an academic career, Miksch started working as a journalist for the *Frankfurter Zeitung* in 1929, where he was chief economics editor until the newspaper was closed down by the National Socialists in 1943.

Miksch's career in journalism did not prevent him from writing his most important work in 1937, entitled 'Competition as Responsibility – Principles of a Competitive System', which he later submitted as his post-doctoral thesis.

After the end of the Second World War, Miksch was actively involved in the rebuilding of the German economy, and until his appointment to the Business College in Mannheim and the University of Freiburg, he was head of department at the Economic Administration in Frankfurt. During this time, he was to become one of Ludwig →Erhard's closest confidants and advisers. It was thanks to Miksch that the 1948 currency reform was embedded into an adequate framework of institu-

tional order policy and was thus a success. The so-called ‘Guiding Principles Law’, on which Erhard based his waiver of price controls which came into force simultaneously with the currency reform and without which a free competitive system would not have been possible, had largely been drawn up by Miksch. Miksch died on 19 September 1950, only six months after his great supporter and friend, Walter Eucken, in Freiburg.

As has been mentioned before, Miksch clearly belongs to the *ordo-liberal* tradition of the Freiburg School. Like Eucken and Böhm, he was not trying to promote a *laissez-faire* type of competitive policy or a policy which keeps aloof from economic processes. Instead, he developed a kind of ‘rule of thumb’ on the basis of which adequate sets of rules (meaning an officially enforceable institutional framework), can be assigned to the different types of markets. This would imply that a monopoly would have to be subjected to government control, while a market which subscribes to complete competition does not require any intervention.

Miksch calls this laying down of an institutional framework, ‘external coordination’. The procedural counterpart, however, is referred to as the ‘internal coordination’. While internal coordination depends on the free will of the market participants and their assessment of mutual benefit, external coordination is always an expression of power.

In order to prevent this power from being used arbitrarily by private individuals, which can happen through monopolies, Miksch developed the model of ‘competition as-if’. He felt that competitive policy must be aimed

at producing, through appropriate institutional measures, a market result equivalent to the result which one would expect under  $\rightarrow$ competition. Thus Miksch advocated neither the absolute prohibition nor the nationalisation of monopolies, but he endorses incentive-oriented governmental regulations, such as they have been implicitly implemented today by the regulatory authority for the postal service and telecommunications.

The arbitrary use of power by the state, however, can be contained by democratic majority decisions. Miksch even came to the conclusion that democracy and the market economy are mutually interdependent. A liberal economic system presupposes a stable democratic system, while the market economy helps prevent the ‘dictatorship of the bureaucracy’, thereby reinforcing democracy.

ACADEMIC CAREER: 1920–1926 undergraduate studies in Chemistry and Political Economy in Prague and Tübingen. 1929 receives his doctorate in Economics at the University of Tübingen. 1937 post-doctoral qualification. 1949 professorship at the National Business College in Mannheim and at the University of Freiburg.

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Heinz-Dieter Smeets  
Michael Sket

**Müller-Armack, Alfred**

Born 28 June 1901

Died 6 March 1978



*Müller-Armack prepared the ground for the concept and coined the term social market economy. He regarded the implementation of a liberal and humane political system as a societal task, to which in its practical form the economy had to contribute.*

Müller-Armack was prolific in his academic work. In his writing, he used *→business cycle policy* – one of the hallmarks of the social market economy – as his point of departure, while his socio-cultural and socio-religious works of the 1930s and early 1940s were inspired by Max Weber, among others. This awakened his interest in investigating economic styles.

According to Müller-Armack, it is attitudes, value judgments and power positions rather than immutable natural laws which shape the different economic and social systems. On the basis

of this premise, one topic runs through Müller-Armack's work like a thread: the significance of social value orientations and whether there is a readiness to assume the responsibility for their realisation.

His work on *Economic Control and Market Economy*, published in 1946, encapsulates his core concept of what a social market economy should be. It was also the first time Müller-Armack developed the idea of a market economy with social responsibility. Here, and in his subsequent writings, the *→social market economy* was conceived as an economic style which must be able to adapt to changing social conditions over time. However, this adaptive ability should not clash with the abiding fundamental principle of the social market economy, which for Müller-Armack consists of the fusion of the precept of a free market with that of social compensation.

From the perspective of *→social irenics* propagated by Müller-Armack, the social market economy comes across as a social idea greater than any specific belief system, built on the principles of economic institutional order theory and unmistakably characterised by the coordination inherent in a market economy.

Having clarified this, he goes on to point out that, for him, the social market economy is not a *→third way* between a *→market economy* and centrally administered economy (*→socialism/planned economy*), but that he sees it as a special type of market economy with an added, inalienable social quality.

Both through his political activities and his academic work, Müller-Armack has earned lasting recognition. In the field of institutional order theory and policy, his concept of a social market

economy has perpetually stimulated deeper reflection. To commemorate what would have been his 100th birthday in 2001, academic symposiums in Bonn and Leipzig provided an opportunity for his colleagues, students and the experts on his theory both in Germany and abroad to honour the memory of Alfred Müller-Armack.

ACADEMIC AND PROFESSIONAL CAREER: Müller-Armack's academic career started with a degree in Political Economy at the universities of Giessen, Freiburg, Munich and Cologne. 1923, doctoral thesis under the supervision of Leopold von Wiese at the University of Cologne ('The Crisis in Social Economic Theory'); 1926, post-doctoral thesis ('The Economic Theory of Economic Stabilisation Policy'). 1926–1938 assistant lecturer and assistant professor in Cologne. After standing in for another lecturer at the University of Münster in 1938, he became assistant professor there the following year, before being appointed full professor of Political Economy and Cultural Sociology with particular emphasis on the sociology of religion in 1940. Concurrently, Müller-Armack was acting director of the Institute for Economics and Social Sciences in Münster. This is where, in 1941, he co-founded a research department for general and textile industry issues in the market economy. 1948 founder member of the scientific advisory committee at the Trade and Commerce Administration in Frankfurt. 1950 Leopold von Wiese's successor at the University of Cologne. The Cologne Institute for Economic Policy in 1950/51 was basically established thanks to Müller-Armack's initiative. 1952–1958 Müller-Armack combined his professorship with the post of acting head of the department for basic guidelines at the Federal Ministry of Economics. 1958 Secretary of State for Europe in the Federal Ministry of Economics under Ludwig →Erhard as Min-

ister; Müller-Armack withdrew from this position in 1963, continuing in his university teaching post until 1969. He remained academically and socially active until his death, something which was reflected in the plethora of tributes he received.

SELECTED PUBLICATIONS BY ALFRED MÜLLER-ARMACK:

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Friedrun Quaas

### **Nell-Breuning, Oswald von**

Born 8 March 1890

Died 21 August 1991

*Oswald von Nell-Breuning was very critical in his comments both on neo-liberalism as the theoretical background and what he liked to refer to as the 'so-called, social market econo-*

my' as its practical derivative, at least during its initial phase during the 1950s (see 'Neo-Liberalism and Catholic Social Doctrines', 1955). It was not until much later ('Is there common ground between Neo-Liberalism and Catholic Social Doctrines?', 1975), with reference to a contribution by Franz →Böhm (*Ordo* 24, 1973, pp. 11-84), that he signalled a conditional chance for reconciliation.

In order to be able to understand this position, one has to go all the way back to the origins of the encyclical *Quadragesimo Anno* (QA, 1931); Nell-Breuning considered himself to be one of its ghost writers. There, Pope Pius XI submits 'capitalist economies', and most particularly their 'empowerment as a result of freedom of competition' (see QA 105-109) to strong criticism while conceding at the same time that it is 'not to be condemned as such' (QA 101). According to him, 'freedom of competition within certain limitations is justified and of undoubted use', but cannot be allowed to become the 'regulatory principle of an economy'. In his view, competition cannot bring about economic 'self-control' because: 'Power is blind – force is tempestuous'. In order to be 'beneficent to mankind, it needs vigorous restraint and wise supervision'. This has to be imposed from outside with the help of 'higher and nobler forces ..., which discipline economic power sternly but with wisdom: →social justice and social love'.

Thus, for Pius XI as well as for Nell-Breuning, the crucial question is: 'How can the economy once again be subordinated to a genuine and thoroughly regulatory principle', after in the liberal capitalism of the past it 'allowed

the practice of destructive individualist theories' (QA 88)? This is precisely what was also important to the 'fathers' of the social market economy, and even today its proponents make this very claim.

### **The 'genuine' regulatory principle**

The core issue in the controversy between Nell-Breuning and certain neo-liberal representatives of the social market economy – particularly that political persuasion in Germany which has made reference to the social market economy since 1949 – is really this 'genuine' regulatory principle. In his critical statements, Nell-Breuning frequently repeats his suspicion that despite all their protestations to the contrary, the neo-liberals regard →competition as the chief 'regulatory' principle because their 'neo-Kantian' theory of knowledge leaves them no alternative.

He claims that for the neo-Kantians, the (economic) common good is only a 'regulatory idea' devoid of a *priori* material content. This means that they are only able to correct the outcome of competition in retrospect, while competition itself is given free reign. Nell-Breuning argues that this comes down to the familiar 'old-liberal' theory, which is simply dressed up with the label 'social market economy'.

The social content of the social market economy in its practical, political application as part of the economic and social policies of Ludwig →Erhard and Alfred →Müller-Armack did not go far enough for Nell-Breuning. Parameters of his criticism were above all industrial relations (Nell-Breuning was a proponent of 'labourism', according to which shareholders, staff and manage-

ment are supposed to be represented on the corporate supervisory boards in equal numbers), and the distribution of the productive capital which in his opinion was insufficient. To that extent, Nell-Breuning was closer to the German trade unions and the Social Democratic Party (SPD) than to the Christian Democratic Union (CDU), and he participated as much in the drawing up of the SPD Godesberg Programme as he made contributions to the magazine *Die neue Gesellschaft*, which touted the SPD party line.

### ***Conditional reconciliation***

But what would a 'true' social market economy look like, to which Nell-Breuning would gladly give his approval? This term is found in the commemorative publication for Franz →Böhm on his 80th birthday (1975) in his most important and final essay on this question.

He mentions his 'personal recollection' of a meeting of the 'academic advisory council of the current Administration for the Economy' in 1948, chaired by Franz Böhm, where the question 'what economic order was to take the place of the war economy which had by then collapsed completely?' was discussed.

A centrally administered economy 'expects every individual to go against his own self-interest almost all the time for the benefit of the common good'. Conversely, it applies 'that in the market economy, self-interest and the requirements of the common good are largely compatible'. Since 'morality is ... the scarcest of all the goods which are in scarce supply', and since the centrally administered economy makes 'excessive

*demands of morality*', one has to turn to the 'market economy which remains functional while placing lower expectations on morality'. Böhm apparently agreed to this statement with the remark: 'The market economy represents *less temptation* for man' (all quotations 469 f.).

This basically meant that Nell-Breuning accepted Adam Smith's 'paradigm change' (Karl Homann) according to which the institution market represents the 'inherent morality' in the economic system, which achieves its ethical goals as an institution and not due to the personal (high) moral quality of the market participants (competitors). This, however, is only a necessary, and not by any means sufficient, condition of a social market economy because, for Nell-Breuning, competition is 'not the regulatory principle of the market economy', but (only) a 'peculiar regulatory instrument' (1968 – see QA 88).

In anthropological terms, the market economy is a consequence of 'private autonomy' and the associated 'removal' of 'obstacles' which might prevent its expression (*ibid*).

Since private autonomy can 'degenerate' to the point of 'the complete destruction of the market economy' (468), a 'market economy requires an institutional order policy' to even be able to keep the 'cultivated plant' (Böhm) market alive. The market as such only knows 'one category of values', which, in accordance with the principle of a rational economy leads to the maxim: 'Minimise costs, maximise profit' (463). Therefore, to opt for a market economy is nothing more than 'an intelligence test' (464).

The market has a value-based ‘control function’ insofar as the market participants have to react appropriately to the ‘scarcity conditions which are signalled by the prices’. However, ‘private autonomy’ with the market as a necessary regulatory instrument does not lead ‘so easily ... to an ordered economy’ (465). In order to achieve that, ‘a regulatory *policy* which ensures both execution and control’ is needed (469).

The anthropological basis for this is the ‘meaning’ of an economy. It is not only supposed to provide the market participants ‘with purchasing power ..., but *everybody* alive, for no other reason, than because they are alive’, as Nell-Breuning approvingly quotes F. Böhm (461).

For Nell-Breuning, this means that a ‘true’ social market economy must not be reduced to the bare bones of government-secured competition, but that the economy as a whole must be regulated and organised in accordance with ‘a world of multidimensional human values’ (463). The market, which is like an ‘illicit worker’ (Böhm), must not control the economy ‘exclusively’, but one must include ‘the possibility of *correcting state interventions*’.

Besides the guarantee of private autonomy, they particularly consist of ‘private property’ and the ‘freedom of contract’, and the procurement of financial means (taxes, duties), through which the government interferes with ‘the free income distribution of the market economy’. They also include the ‘monetary order which is anything but automatically controlled’, economic stabilisation and structural policy. According to Nell-Breuning, it is particularly the latter which puts ‘the econ-

omy *on another path*’ than the one where market forces are left to themselves’ (467).

A summary of Nell-Breuning’s attitude to the social market economy must emphasise three main aspects:

- Nell-Breuning is deeply opposed to the alleged ‘self-control’ of the economy by a ‘hypostatisation’ of the market, which is no more (but also no less) than a regulatory instrument, which, however, is an inevitable consequence of human autonomy.
- Nell-Breuning warns particularly against the ‘agglomeration of excessive private power’, which has a destabilising effect on the ‘minimal market *equilibrium* of functional private autonomy’ and which must lead to the degeneration of the →*market economy*. (468).
- For Nell-Breuning, the social market economy necessitates a →*social state* with built-in redistribution and structural policies. This is supposed to fulfil optimally the true objective of the economy, i.e. supplying *all* men/women with ‘the basic necessities of life’ (461).

Nell-Breuning’s last word on the subject is that if this view of the social market economy is ‘authentic neo-liberalism’, ‘then, and only then, are neo-liberalism and the Catholic social doctrines reconciled with one another’ (469).

The question remains, however, whether such a reconciliation would have been possible not only with the ideas of Franz Böhm, but also (even



before 1975) with Alfred →Müller-Armack and others who were disappointed by Nell-Breuning's critical attitude towards the theory and practice of the social market economy which they represented.

ACADEMIC AND PROFESSIONAL CAREER: From 1928, Dr theol., Dr rer. h. c. (honoris causa) Nell-Breuning was professor of Moral Theology and Social Sciences at the College for Philosophy and Theology at St. Georgen in Frankfurt. He was a member of the Scientific Advisory Council at the Federal Ministry of Economics for 17 years, as well as an honorary citizen of the cities of Trier and Frankfurt.

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Lothar Roos

**Nipperdey, Hans Carl**

Born 21 January 1896

Died 21 January 1968

*In Nipperdey's opinion, the Basic Law, although it contains no special section on the economic constitutional framework, incorporates basic economic, constitutional and legal principles which in their entirety guarantee the system of the social market economy. He felt that the market economy, characterised as it is*

*by the principle of the social state in terms of Articles 20(1) and 28(1) of the Basic Law, and which is modified into the social market economy, had to be seen as a constitutional principle inherent in the fundamental rights, above all the general freedom of action (Article 2(1) Basic Law), freedom of occupation (Article 12(1), Basic Law), freedom of association and coalition (Article 9(1) and (3), Basic Law) and the guarantee of property (Article 14(1), Basic Law). However, Nipperdey's opinion was not universally accepted, since the Federal Constitutional Court and the greater part of the literature were presupposing that the Basic Law was neutral as far as the legal aspects of the economic constitutional framework were concerned.*

Nipperdey's extensive academic work, for which he received numerous honours both in Germany and abroad, is reflected in over 400 publications. He was involved in all areas of civil, commercial and economic law, in copyright and competition law as well as in labour law.

But Nipperdey also made a significant contribution to the establishment of a constitutional framework in these areas. During his Weimar period, he published the compendium *The Reich Constitution and its Basic Rights and Obligations*. It contained his commentary on the right of coalition in terms of Article 161 of the Weimar Reich Constitution.

After the Second World War, Nipperdey, Scheuner, Neumann and Bettermann co-published the *Manual on the Theory and Practice of the Fundamental Rights*, which included his work on the topics 'human dignity' and 'free personal expression'. Particularly his views on the third-party effect of

fundamental rights in civil law and the constitutional guarantee of the →*social market economy* received a great deal of attention both in the literature and in the jurisdiction, and have retained their validity to this day.

Nipperdey's comments on the legal content of the economic constitutional framework in the Basic Law are equally still relevant today, in that they explicitly state that the neutrality of the Basic Law is not absolute to the extent that the government is free to adopt one of the types of a centrally administered economy or turn to planned economic coordination (→*socialism/planned economy*) at will.

In actual fact, the fundamental rights which have economic and legal relevance impose boundaries on the legislature, while establishing a basic decentralised structure of competencies within the economy, making it indeed possible to regard the fundamental rights as instrumental in the establishment of this economic system. Nowadays, the EC Treaty (in particular Article 4(1)) contains a declaration of the principle of a →*competition*-based →*market economy*, so that at the level of the European Community at least, a solid legal framework secures the market economy.

ACADEMIC AND PROFESSIONAL CAREER: Nipperdey was the son of a general practitioner. After graduating from high school in Weimar, he took up law at the universities of Heidelberg, Leipzig and Jena. Having been a volunteer in the First World War, he received his doctorate in 1917 ('Limitations to Extortion by Threat, with Particular Reference to Industrial Action'). He was awarded his post-doctoral qualification in Jena in 1920 ('Contracting Obligation and

Dictated Contract'). There he became assistant professor in 1924. 1925 Chair of Civil Law, Trade and Commercial Law and Industrial Law at the University of Cologne as a full professor. Despite numerous offers from other universities, he remained loyal to this university until the end of his life. In 1954, he was appointed the first president of the newly established Federal Labour Court at Kassel. He retired from judicial office in 1964 at the age of 68, but continued as a lecturer and researcher at the University of Cologne even after his retirement, just as he had continued to do while in judicial office in Kassel.

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Hans-Jürgen Papier

#### Röpke, Wilhelm

Born 10 October 1899

Died 12 February 1966

*Röpke is in no doubt that the framework of a →social market economy must include the law, the state, customs and morals, firm convictions about norms and values and a reliable monetary system that is not dependent on the automatism of the market, but for which the central bank and the government have to take responsibility on a daily basis. Then there have to be economic, social and financial policies which are 'beyond the market' and balance interests, protect the weak, limit power, impose rules and monitor their*



observance. The capital market, investments and foreign trade are the key areas and they must not be distorted by government interference in the market process. The individual principle that lies at the heart of the market economy has to be kept in balance by the social and humanitarian principles that characterise the framework and its different elements. The will to justice generates a 'concept of liberty', affirming solidarity as a basic value. Part of this is an adequate share in the national income for everyone. In this way, gross inequalities in the manner in which the national income and the national capital are distributed can be balanced.

Röpke refers to his economic ideal as 'economic humanism' or the 'third way'. The theory behind his economic policies is based on the postulate that human dignity is sacrosanct. He wants to create a social and political environment where respect for human rights is the first essential. The proponents of a liberal state should see Röpke's work as a beacon, a *civitas humana* 'beyond supply and demand'. He wants science, politics and the public always to be reminded of the fact that one must

*keep striving for solutions which are appropriate for their time in order to make the fundamental principles of the 'social market economy' a reality.*

For Röpke, economics was always political economics. In his opinion, the economic reality of his time was politicised to an extent that was previously unheard of or completely inconceivable. This view was borne out by Röpke's own experiences. As early as 1931, as a member of the *Reichs* Commission for the investigation of the unemployment issue (the Brauns Commission), Röpke suggested that the private initiative which, for a host of reasons was lacking, should be replaced by suitable government-financed demand for the purpose of giving the economy a boost. He argued that economic activity could be kick-started by giving it an 'initial push', and that in this way →unemployment could be gradually diminished.

As early as 1923, Röpke was trying to communicate the need for an 'innovative' synthesis of 'liberalism, social responsibility and loyalty towards the law'. In this way, he felt that the two extremes of *laissez-faire* on the one hand, and the exclusive focus on the common good on the other could be avoided.

No intelligent individual could deny the fact that the Western economic system with its characteristic features including private ownership of the means of production, highly differentiated levels of production and a long list of individual liberties was particularly suited to the creation of prosperity. To abolish these liberties in order to overcome the 'late capitalist' system seemed to Röpke tantamount to con-

sciously ushering in a 'totalitarian state' or a political dictatorship. Röpke cautioned against the National Socialist promise of a 'new, grandiose, but otherwise nebulous 1000-year empire' and the consequences of the political hysteria that was a symptom of the time. He insisted that national socialism was a radical ideology incompatible with a liberal state. Röpke predicted that on top of the economic crisis, Germany would be plunged into a political crisis and that everybody who gave his vote to the National Socialists would be voting for 'chaos instead of order and for destruction instead of construction'.

When Röpke opted for emigration in 1933, his decision was prompted by the desire to remind the rest of the world that there was still 'another Germany' (for example, the Freiburg Circle with members like Franz →*Böhm* and Walter →*Eucken*). He was drafting an economic and social order for the post-National Socialist era, based on the idea of a society where economic equilibrium is linked to the postulates of social justice and equality, and which is 'aware of the significance of moral values for the socio-economic survival of the nations'. These are the words Ludwig →*Erhard* used on Wilhelm Röpke's 60th birthday to highlight the significance of his thinking for the development of the concept of the social market economy.

ACADEMIC AND PROFESSIONAL CAREER: Undergraduate degree in economics in Göttingen, Tübingen and Marburg. Doctorate (1921) and post-doctoral qualification, then assistant lectureship in Political Economics in Marburg (1922). After appointments to Jena as assistant professor (1924) and to Graz as full professor (1928),

he returned to Marburg as professor of Political Economics (1929). He remained there until he was dismissed by the Hitler regime in 1933 for political reasons. From late-1933 until the winter semester of 1937/38, he was director of the Institute for Social Sciences at the University of Istanbul, before taking up a professorship of International Economic Affairs at the *Institut Universitaire des Hautes Etudes Internationales* in Geneva, where he remained until his death.

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*Hans-Günter Krüsselberg*

#### **Rueff, Jacques**

Born 23 August 1896

Died 23 April 1978

*As a French political economist, a financial expert and a politician in the fields of finance and economic affairs, Rueff combined, like almost no one else, innovative contributions to economic theory with a successful activity in the practical economic policy and public administration. He influenced the French monetary and economic policy more strongly than any other academic or politician. Rueff always advocated a liberal economic system and a liberal economic policy, even at times when this was not popular. With his theory of*

*property rights, his battle against inflation, his criticism of the application of the gold standard to foreign exchange, his suggested stability policies and his suggestions to tie the monetary policy to rules, Rueff was ahead of his time. Some of his reform suggestions became accepted practice; for example, in the European monetary system and in the →European Economic and Monetary Union.*

Rueff's most important theoretical work is *L'ordre social* (1st ed 1945). The title of the German translation as *The Social Order* (1952) is misleading; 'The Economic and Social Order' would be more correct. On the basis of price, production, monetary and market theory, Rueff in this work develops an inflation theory and a theory relating to the economic and social order. He starts with the then innovative idea (hardly appreciated by most critics) that each good's exchange (purchase, sale) in the market is an exchange of property rights (*droits de propriété*). This makes Rueff the most important forerunner of the modern property rights theory.

Rueff also uses the property rights theory to explain inflation: the state creates 'fake' (or 'false') property rights in order to finance budget deficits by forcing the (instruction-dependent) central bank to accept basically worthless government stocks as the basis for the creation of central bank money, which is put at the disposal of the state for the purpose of demand for goods and services. If the price increases caused by this additional demand are suppressed by a price and wage freeze, instead of open inflation, 'repressed' inflation (*inflation réprimée*) will develop.

The battle against inflation and for currency stability forms a recurring

theme for Rueff's practical work on economic policy. Already in 1926 he took important preliminary steps for the stabilisation of the exchange rate of the franc and the re-establishment of the gold convertibility of the franc by Prime Minister Poincaré.

On the basis of purchasing power and wage parities, Rueff worked out an exchange rate for the franc which was implemented through the introduction of the 'franc Poincaré' and which was stable and could be converted into gold. By choosing the correct exchange rate, Rueff maintained that the return to the gold currency in France did not entail – as it previously had in Great Britain – deflation and falling wages.

Rueff's most important achievement is certainly the conception of the 1958 economic and currency reform in France, which even goes back to his initiative.

The economic situation in France in 1958 had reached crisis point: a high budgetary deficit, inflation, flight of capital, shrinking foreign exchange reserves, exchange control, import protectionism, the loss of international competitive ability and devaluation pressure. On Rueff's instigation, a committee which he chaired compiled a consistent reform programme for the government, which in 1958/59 was put into practice by Head of Government de Gaulle and the Finance Minister Pinay:

- In order to stop inflation, the financing of household deficit by the central bank had to be prohibited and the deficit itself eliminated.
- For the elimination of the budget deficit, taxes had to be increased and

consumptive public expenditure – especially →*subsidies* – had to be reduced: however, national capital expenditure was increased (→*public expenditure*).

- Index-linked wages and other →*incomes* were abolished.
- In order to prevent price increases, a large number of quantity restrictions for imported goods were waived: this generated competitive pressure from imports.
- In order to restore the competitive ability of the French economy, which had been impaired by inflation, the franc was devalued.
- Simultaneously, as a ‘confidence-building measure’, a new currency, the ‘new franc’ (= 100 old francs), was created and the convertibility of the franc was introduced, i.e. exchange controls were abandoned.

The reforms proved a great success. The French post-war inflation was suddenly over, the national budget was reorganised, the exchange rate was stabilised, the balance of payments was adjusted, economic growth was secured for years to come and the French economy was made competitive for the Common Market.

For the elimination of the remaining obstacles, in 1959/60, again on Rueff’s initiative, a second committee of experts chaired by Rueff and Louis Armand compiled a report on the hindrances to economic growth (Rueff Armand report). This constituted the world’s first →*deregulation* programme

and included recommendations for the removal of restraints of competition, restrictions to market entry, government price-fixing and the rigidity of the job market – as well as improvements in the educational system and in administration.

Since 1961 Rueff made a name for himself as a critic of the Bretton Woods ‘world monetary system’, which was in force at the time. The gold dollar standard of the time made it possible for the key currency country – which was the United States (US) – to maintain budget deficits and balance of payment deficits financed by inflation for many years, without being forced to devalue the dollar and impose an inflation freeze. Thus the dollar reserves of the foreign central banks kept growing (which led to an imported inflation in those countries).

Rueff soon saw the danger that the gold reserves of the US would no longer suffice to keep the formally existing obligation for the redemption of these dollar reserves in gold. He feared as a consequence either a deflation crisis in the US or the abolition of the gold convertibility of the dollar. The latter actually occurred in 1971.

In order to overcome the instability and susceptibility of the gold dollar standard to inflation, Rueff suggested the return to the international gold standard: the monetary policy of the central banks should thereby be subjected to rules; for the reconciliation of the balance of payments deficits only gold transfers were to be used instead of foreign exchange. Countries with balance of payments deficits would thereby have been subjected to an obligation to adopt stability policies. President de

Gaulle gave Rueff's reform suggestions his support, but was not able to implement them internationally.

ACADEMIC AND PROFESSIONAL CAREER: Subsequent to his military service, he entered the *École Polytechnique* in Paris in 1919. From 1922, lecturer in Statistics and Mathematical Economics at the University of Paris. A pre-selection examination in 1923 (Concours) opened up the career of *Inspecteur Général des Finances*, one of the most distinguished positions in the French administration. 1927–1930 member of the Economic and Financial Committee of the League of Nations (Geneva), 1930–1934 finance attaché at the French embassy in London. From 1931, professor of Political Economy at the *École Libre des Sciences Politiques*, Paris (subsequently *Institut des Sciences Politiques*). 1934–1939 at the French Treasury, 1939–1940 vice-president of the French central bank. From 1945 on, he was an economic adviser to the French Military Government in Germany. From 1952 on, he was on the bench at the Court of Justice of the European Community for Coal and Steel. 1958–1962 at the European Court of Justice. During the 1960s, he was an economic advisor to French President de Gaulle. Member of the *Académie Française* and the *Académie des Sciences Morales et Politiques*.

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Josef Molsberger

## Rüstow, Alexander

Born 8 April 1885

Died 30 June 1963



*'If you need a helping hand, first look for it at the end of your right arm.'* This favourite expression of Rüstow's illustrates his deep conviction that on the basis of freedom and individual responsibility, everybody should make the effort to organise and secure his own existence to the best of his abilities, while expressing his creative energy in his (immediate) environment. But it was a long time before Rüstow came to this conclusion. After a broad classical education, he studied the theory of →socialism as well as that of →liberalism in detail, ending up in the opposition and eventually in exile during the Third Reich. As early as 1932, and having experienced the ongoing economic crisis during the Weimar Republic, Rüstow took a determined stand against interventionist economic policies by the state (→interventionism). The state should rather be a referee, concentrating on the creation of and the adherence to the economic and socio-political framework. Competition as the fundamental coordinating principle in a market economy helps to create and preserve space for personal decision-making and acting.

*Rüstow's aim was a liberal society which puts people first and is organised in such a way that the behaviour that comes naturally to humans is captured and put to good use. Rüstow developed this concept of a social order because he was interested in a large variety of topics, and finally put what he had learnt from his research in cultural history, sociology and economics together, as in a jigsaw puzzle. Because Rüstow was one of the pioneers of this sort of concept, he is now, together with Walter →Eucken, Wilhelm →Röpke, Alfred →Müller-Armack, Franz →Böhm and Ludwig →Erhard considered one of the founding fathers of the →social market economy.*

In the social system conceptualised by Rüstow, where democracy and the →market economy are totally interconnected, different spheres of interest exist, which he classifies as economic and supra-economic. For Rüstow, the economy holds a subordinate position in that it merely serves the purpose of satisfying the material needs of separate individuals and society as a whole. →Competition is seen as the main organising principle of the market. But at the same time, the institutional order policy framework imposes boundaries on the competition among the economic agents in the market, preventing the formation of monopolies and distorted competition. All the other areas of life – such as culture, education and family, ethics and religion – are more important to Rüstow than the economy; he argues that in these areas of life, behaviour is controlled by moral values.

Rüstow wants to complement this institutional order policy framework with a comprehensive, coherent social policy, which he refers to as 'vital poli-

cy'. Through this vital policy he wants to organise the daily life of the individual in his family situation, in his living and work environment, thus ensuring a humane existence. Rüstow sees his vital policy concept as a part of economic policy and therefore subjects it fundamentally to the same expectations. For the vital policy, the principles of market conformity, subsidiarity and the basic equivalence of service and counter-service as part of the economic exchange process apply accordingly.

Social policy issues, such as social security, equal opportunities, equal access to education or housing and →family policies, can only be dealt with in the context of neo-liberal order concepts. For Rüstow, the social question is thus essentially a part of the question of the economic order.

In order to implement this neo-liberal economic and social system, Rüstow explains what he expects from every member of society: he expects people to treat one another with consideration and responsibility, while showing respect for the needs of others. In addition, he makes repeated appeals to the people to take their fate into their own hands and to do their best to preserve their own personal freedom and thus to ensure a free society.

Rüstow had a marked influence on neo-liberalism and its development. In particular on:

- the intellectual background of the neo-liberal economic and social order, and its distinction from →socialism and (old) economic liberalism;
- clarifying the importance of an insti-



tutional framework for a lasting peaceful economic and social order; and

- the identification of the supra-economic variables with an impact on human life.

In reality, the economic policy-makers since 1948 have only paid limited attention to Rüstow's principles of subsidiarity, performance-based reward and consistent economic behaviour.

Besides the many occasions when the realisation of the social market economy was compromised, it could be explained by the fact that the development of the complex neo-liberal economic and social order on the one hand, and its political implementation on the other, was handled by many different people. It can therefore be assumed that those making the political decisions at the time lacked a detailed understanding of the way a neo-liberal institutional framework should be organised.

Until late in life, Rüstow never tired of lending support to a systematically organised social market economy, for example, in his capacity as head of the Social Market Economy Action Group (ASM) and by way of political consultancy.

ACADEMIC AND PROFESSIONAL CAREER: 1903 school-leaving certificate with emphasis on the Classics in Berlin; 1903–1908 undergraduate studies in Classical Philology, Philosophy, Mathematics, Physics, Law and Economics in Göttingen, Munich and Berlin. 1908 doctorate in Classical Literature on the Paradox of the Cretan Liar ('The Liar. Theory, History and Solution', Leipzig 1910). 1908–1914 editor at a renowned Berlin publishing firm for classical texts.

1914–1918 military service with the artillery, later promotion to reserve lieutenant; awarded the Iron Cross 1st and 2nd class. 1919–1924 consultant for cartel issues at the National Ministry of Finance. 1924–1933 head of the Economic Policy Department at the Association of German Mechanical Engineering Institutes. 1933–1949 professor at the University of Istanbul in the Chair of Economic Geography and Economic and Social History. 1949–1956 professor at the University of Heidelberg, in the Chair of Economic and Social Science. 1955–1962 chairman of the ASM.

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Jan Hegner

**Schiller, Karl**

Born 24 April 1911

Died 26 December 1994

*Not many people are able to combine academic and political careers. But two who succeed-*

ed left their mark on the economic policy of the Federal Republic of Germany: first Ludwig →Erhard, then Karl Schiller. Both were academics before they became politicians, both experienced the tension between economic theory which is for the medium- or long-term, and the short-term nature of political practice. Schiller had a gift for detailed analysis combined with great rhetorical brilliance and persuasive power. In the course of his academic and ministerial career, he turned more and more towards the →market economy. This is why he bequeathed his extensive specialist library to the Walter-Eucken Institute in Freiburg.

In 1953, Schiller coined his famous motto 'Competition as far as possible, planning as far as necessary', which despite some resistance was incorporated into the 1959 Godesberg Programme of the Social Democratic Party (SPD). The collection of essays published in 1964 under the title *The Economist and Society* had the subtitle 'Liberal and social elements in modern economic policy'.

While Schiller was Federal Minister of Economic Affairs under the great coalition, the Stability and Growth Act was adopted in 1967. It bore his stamp in many essential passages. Schiller himself later assigned increasing importance to competitive →institutional order policy and became the 'market conscience' of the SPD. He was in favour of the reunification of the two German states in general, while being critical of it in detail.

ACADEMIC CAREER: 1931–1935 undergraduate studies in Kiel, Frankfurt, Berlin, Heidelberg. 1934 graduated in economics. 1935 doctorate in political sciences.

1935–1941 head of a research group at the Institute for Economics at the University of Kiel. 1939 postgraduate lecturing qualification in Kiel. 1941–1945 military service. 1944 offer of a position at the University of Rostock (not taken up). 1946 visiting professor at the University of Kiel. 1947–1972 professor at the University of Hamburg (1956–1958 rector). 1958–1960 member of the Scientific Advisory Council of the Ministry of Economic Affairs.

POLITICAL CAREER: 1946 joins the SPD. 1948–1953 senator for Economic Affairs and Transport in Hamburg. 1949–1953 member of the Upper House of Parliament. 1961–1965 senator for Economic Affairs in West Berlin. 1964 voted on to the executive committee of the SPD. 1965 Member of Parliament, deputy party chairman and SPD parliamentary group speaker on economic affairs. 1966–1972 Federal Minister of Economic Affairs, and from 1971 also Federal Minister of Finance. 1972 resignation because of fundamental differences of opinion on fiscal policy. 1972 withdrawal from the SPD, 1980 re-entry. Later extensive mediation and especially consultancy work, also abroad.

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Egon Tuchtfeldt

**Schleyer, Hanns-Martin**

Born 1 May 1915

Died 18 October 1977

*Schleyer laid down his socio-political credo – the conviction ‘that every political action is determined by the concepts of liberty, tolerance, performance’ – in his book The Social Model, published in 1973. Here, he uncompromisingly turns against any interference with the →market economy which is not inherent in the system.*

Schleyer read Law and Political Science (1933–1938) in Heidelberg and Karlsruhe, and Economics in Prague (graduation 1941). He received a doctorate in Law in Innsbruck in 1951. During his academic training he was involved in student social work. Following his military service, he saw action and was discharged from the army on medical grounds. From 1942 to 1945, Schleyer held a position at the Central Industry Federation of Bohemia and Moravia in Prague. From 1945 to 1948 he was first a French prisoner of war and then director of foreign trade at the Chamber of Commerce and Industry in Baden-Baden. In 1952 he joined Daimler-Benz, the Stuttgart automobile company, where he became a deputy board member in 1959 and a full member in 1963 with responsibility for human resources, social and training policies. In 1976 his responsibility in this large corporation was extended to basic company policy and social issues.

It was not long before Schleyer played a prominent role in the federations. From 1962 to 1968 he was chairman of the Metal Industrialists’ Federation of Württemberg-Baden. In

1972, he was elected chairman of the Metal Industry Federation of Baden-Württemberg, before becoming deputy chairman of *Gesamtmittel*. In 1973, Schleyer agreed to take over the office of the president of the Federal Union of German Employers’ Associations (Federal Employers’ Association) whose vice-president he had been since 1965. Schleyer was elected president of the Federal Association of Industries with effect from the beginning of 1977. This is how, for the first time, both large federations had the same chairman. On Schleyer’s initiative, they became more focused on social and socio-political problems. Schleyer, as a representative of the German economy, was kidnapped on 5 September 1977 by a terrorist group and found murdered in a parked car on 19 October 1977 in Mülhausen, Alsace.

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Franz Schoser

**Schmölders, Günter**

Born 29 September 1903

Died 7 November 1991

*Schmölders was deeply sceptical of the idea of the state as the ‘benevolent dictator’, which features in large tracts of contemporary economic theory and where market failure is mentioned more frequently than government failure. During the Second World War, he had been close to the Kreisau Circle and the men of the 20 July 1944 assassination attempt on Adolf Hitler. After the war, he joined the Social Market Economy Action Group (ASM) and was an active member of*

*the Mont Pèlerin Society, an international association of liberal economists. Thus Schmölders regarded it as an apt description when, on his 85th birthday, a speaker referred to him as 'a dyed-in-the-wool liberal'.*

Schmölders was always concerned with the practical side of economics, with a special focus on public finance and money. He did not develop mathematical models but was involved in empirical research on socio-economic behaviour on the basis of sociological and socio-psychological methods.

Titles like *The Irrational Aspect of the Public Finance System* (Hamburg, 1960) and *Finance and Tax Psychology* (Hamburg, 1970) yielded useful results for the study of finance (as public finance theory) and were incorporated into the major works on financial theory: *Financial Policy* (3rd ed, Berlin, Heidelberg, New York, 1970) and *General Introduction to Taxation* (5th ed, Berlin, 1980, this edition in cooperation with K.-H. Hansmeyer). He used the same methods to deal with financial issues. Accordingly *The Psychology of Money* (Reinbek, 1966) and *Good and Bad Money* (Frankfurt, 1968) can be seen as preliminary studies for his *Monetary Policy* (2nd ed, Tübingen, Zurich, 1968).

Today, one would group Schmölders with the new →*institutional economics* and the public choice school because – ahead of his time – he considered the personal interests of those involved (*Politicians and the Currency*, Frankfurt, 1959), and the influence of the parties and federations on the formation of the political will and thus on economic policy.

ACADEMIC AND PROFESSIONAL CAREER: Doctorate and post-doctoral lecturing qualification in Berlin, 1934 professorship in Breslau (as successor of Karl Bräuer); from 1940 until his retirement in 1971 professorship in Cologne (as successor of Erwin von Beckerath) and at the Research Institute for Finance founded by Fritz Karl Mann in 1927; 1965/66 rector, honorary doctorates from Innsbruck and Gent. From its establishment in 1950 until 1975, member of the Scientific Advisory Council at the Federal Ministry of Finance. From 1959, full member of the Academy of Sciences and Literature in Mainz. 1969, Order of Merit of the Federal Republic of Germany, 1st Class. Symposium at the Berlin Centre of Sciences in 2003 to mark the centenary of his birth.

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Horst Zimmermann

#### Schreiber, Wilfrid

Born 17 September 1904

Died 23 June 1975

*Schreiber was surely one of the outstanding social politicians of the post-war period. Before embarking on his academic career, he held the position of general secretary of a federation of industrialists. Even then, he used to voice his opinions, based on the →Catholic social doctrines, on issues of family burden compensation, →co-determination, →wealth accumulation policies for the workforce and especially →pension reform.*

His most important scientific contribution was the Schreiber Plan, whose underlying idea was that ‘an adequate proportion’ of wage-earners’ incomes should be allocated to children and adolescents not yet capable of, and engaged in, gainful employment (as a youth pension) on the one hand and, on the other hand, to those no longer earning an income (as an old-age pension).

Old-age pensions were to be initially determined by the level of income earned in each case and by the contributions paid by each member during his active working life, while the so-called existing pensions were supposed to be linked to the annual development of earned incomes.

This ‘dynamisation’ of pensions means that those no longer gainfully employed are able to partake in prosperity developments.

Schreiber’s idea of a youth pension dates back to 1951, but has gained new topicality. It is based on the view that a society not only has the duty to look after those no longer gainfully employed, but that it should also provide for those who are not yet capable of, or engaged in, earning an income. His suggestion that not only parents but society as a whole should provide financially for the younger generations, was not implemented. This political omission was bound to undermine the long-term financial stability of old-age pensions in a society where, because of an increased lifespan on one hand and a strong decline in the birth rate on the other, fewer and fewer employed people have to provide for more and more pensioners.

In a society where those who have not brought up children receive, under

otherwise identical circumstances, the same pension payouts as those who have brought up and looked after children, →*social justice* is seriously compromised.

In the commemorative publication (*Festschrift*) mentioned below, Federal Chancellor Kiesinger was right to stress that Schreiber had ‘made a significant contribution through his scientific research, his socio-political involvement in the Federation of Catholic Entrepreneurs and in advising the federal government on social policy issues for the advancement of our social policy’.

ACADEMIC AND PROFESSIONAL CAREER: 1922–1930 studies in Economics and Social Science (Cologne), Engineering (Aachen and Munich) and Mathematics and Physics (Cologne). 1931–1947 journalist. 1947 further studies in Economics and Social Science at the University of Bonn leading to his doctorate in 1948 under Erwin von Beckerath. 1955 post-doctoral lecturing qualification. 1949–1959 general secretary of the Federation of Catholic Entrepreneurs. 1960–1972 chair for Social Politics at the University of Cologne.

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**Stoltenberg, Gerhard**

Born 29 September 1928

Died 23 November 2001

*Stoltenberg's personal experience of the misery of the war and post-war years – he was a young anti-aircraft auxiliary in British captivity when the war ended – and the fact that he had grown up as the son of a protestant minister, his broad knowledge of history and the arts as well as firm Christian values produced in him a profound scepticism of euphoric planning and faith in the controllability of social and economic processes, which dominated the 'modern financial policy' of the late-1960s and the 1970s. Stoltenberg wanted, promoted and practised a financial and economic policy based on social and ethical principles along institutional order policy lines and functioning as a conceptual unit of budgetary, fiscal, monetary and privatisation policies.*

His goal was an economic order conceived as the core of a liberal constitution, while he saw a need to resuscitate the revitalising forces of the social market economy. The situation at the beginning and at the end of his term in office as Federal Minister of Finance from 1982 until 1989 reflect the effectiveness of Stoltenberg's policies. But he was at times only able to implement these in greatly diminished form because of a lack of support by the governing bodies of the coalition and by the public, whose faith in the basic tenets of institutional order policy tended to be fickle.

Konrad Adenauer and Ludwig →Erhard were the main points of reference for Stoltenberg's practical policies, with Walter →Eucken, Alfred →Müller-Armack and Wilhelm →Röpke forming the theoretical background. He joined the Christian Democratic Union

(CDU) in 1947 and was, as a young student of history, the social sciences and philosophy, deeply impressed by Erhard's liberating act of abolishing rations and similar economic interventions and by the optimism, confidence and economic dynamism this created. Economic prosperity had proved to be the right foundation for a stable democratic system.

Stoltenberg was planning to bring about a renewal of the social market economy. The excessive demands on financial policy during the 1970s meant that budgetary expenditure had to be curbed in order to reduce the government's share of total expenditure. Furthermore, a restructured tax system was to stimulate growth and ensure the recognition of personal achievement.

In 1982 Stoltenberg set out to break the pattern of a constantly growing state share of the total economy and constantly growing public expenditure.

Consolidation became the main aim of his financial, economic and social policies. The state ratio decreased from 51.9% in 1982 to 45.8% in 1990. In 1989, both the regional government authorities and the social security schemes achieved their first budget surpluses in almost 20 years, and in the same space of time the regional government authorities reduced their deficit from €32.2 billion to €6.4 billion. The federal government's net borrowings decreased from DM37.2 billion in 1982 to DM19.2 billion in 1989. Stringent economic measures together with increased revenue thanks to a prospering economy, were responsible for this development.

It would have suited Stoltenberg's economic policy thinking if after the

successful quantitative consolidation of the early years, he could have focused his energies on the qualitative improvement of public budgets, by allocating more money to investments for the future. He had succeeded in doing this as Federal Minister of Science and Research under Federal Chancellor Erhard, but the markedly more relaxed financial situation in general meant that the coalition, as well as the federal states and municipalities, did not feel an urgent need for reforms. Nobody realised then that the social security system should have undergone far-reaching reforms; on the contrary, more long-term projects causing increased expenditure were approved and the cut-back of subsidies ground to a halt.

Without these palpable successes and consistent consolidation policies, the three-phase tax reforms of 1986, 1988 and 1990, with net savings of approximately €25.6 billion, would not have been possible. In 1990, the tax rate reached a 30-year low at 22.5%, compared to 23.8% in 1982. Special burdens for the federal states and municipalities were avoided and their financial position was improved.

The objective was a complete overhaul of the tax system, which would go far beyond lower taxation. Direct taxes were to be lowered for good, while the tax law was supposed to promote growth and favour families, making Germany more attractive as a location for future investments in a climate of increasingly fierce international →*competition*.

Despite the fact that the first phase mainly helped smaller →*income* earners, incorporating patently family-friendly elements, the new linear-progressive tariff had lasting advantages for all. But

distribution policy issues together with tax exemption for aviation fuel, discounts for one-year-old cars, extra pay for Sunday work and taxation at the source were beginning to dominate the picture. And there were setbacks associated with the expanding assessment basis, i.e. the reduction of fiscal →*subsidies*.

Stoltenberg overestimated the key figures in politics and economics and their commitment to institutional order policy and genuine reforms as much as he overestimated the level of economic expertise in public debate. Science, economics and politics nevertheless regard his fiscal policy in an extremely positive light, not least in view of the situation before and after his term of office.

In close cooperation with the Federal Bank, Stoltenberg achieved the stability-oriented union of monetary and fiscal policy. Just like the markets, the financial guardians trusted his policies. The discount rate, which in 1983 was still 7%, came down to 3% in 1987 and the capital market interest rate followed suit. Everybody at home and abroad was impressed to see the central bank and the treasury closing ranks when it came to the organisation of the monetary institutional framework.

The cooperation with the Federal Bank proved its value during the turbulence of financial crises, the parity debate in the European Monetary System (EMS) and in the debt crises of important emerging markets, as well as in the stock exchange crash in the autumn of 1987. Stoltenberg's unusual competence and reliability made him the unofficial leader of the G-7 ministers of finance. On 15 March 1988, in his declaration of principle on the

future of the European currency area, Stoltenberg highlighted the German point of view with regard to a stable development of the EMS, clearly distinguishing it from nebulous and unrealistic foreign policy concepts.

Stoltenberg's comprehensive outline of federal privatisation and public investment policy, which was adopted by the Federal Cabinet on 26 March 1985, reflects the absolute priority of private → *property* and private initiative in his theoretical and practical approach to the market economy. In the years to come, the federal government privatised a large proportion of its industrial properties.

The almost seven years of Stoltenberg's responsibility for financial policy were proof that a renewal of the social market economy can bring success, greater prosperity, social justice and faith in democracy. Thanks to these policies, the Federal Republic was able to carry the economic burden of German unity.

PROFESSIONAL CAREER: 1944–1945 military service, 1949 school-leaving certificate, undergraduate studies in History, Social Science and Philosophy at Kiel, 1954 doctorate, assistant lecturer at the University of Kiel, 1956 assistant lecturer, then lecturer, at the Kiel Educational College. 1965 and 1969–1970 director of Friedrich Krupp GmbH. 1947 member of the CDU, 1955–1961 Federal chairman of the Junge Union, 1955–1971 deputy state chairman of the CDU in Schleswig-Holstein, from November 1971 state chairman, 1969 deputy Federal chairman of the CDU. Member of the Federal State Parliament of Schleswig-Holstein 1954–1957 and 1971–1982. Member of the *Bundestag* 1957–1971. 1965–1969 Federal Minister of Science and Research, thereafter Deputy Chairman of

the CDU/CSU faction in the *Bundestag*; 1971–1982 State President of Schleswig-Holstein. 1982–1989 Federal Finance Minister, then until 1992 Federal Minister of Defence; from 20 January 1993 until 30 March 2001, Deputy Chairman of the Konrad-Adenauer-Stiftung.

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STOLTENBERG, G. (1954), *Der Deutsche Reichstag 1871 bis 1873*; — (1960), *Die politischen Strömungen im schleswig-holsteinischen Landvolk 1919–1933*; — (1968), *Hochschule Wissenschaft Politik*; — (1969), *Staat und Wissenschaft*; — (1978), *Schleswig-Holstein heute und morgen*; — (1986), *Unsere Verantwortung für eine gute Zukunft*; — (1997), *Wendepunkte*; KONRAD-ADENAUER-STIFTUNG (ed) (1999), *Das Konzept der Sozialen Marktwirtschaft*, (with a foreword by Gerhard von Stoltenberg), Sankt Augustin; SCHLECHT, O./STOLTENBERG, G. (ed) (2001), *Soziale Marktwirtschaft. Grundlagen, Entwicklungslinien, Perspektiven*, Munich.

Peter Wichert

### Stützel, Wolfgang

Born 23 January 1925

Died 1 March 1987

*Wolfgang Stützel was one of the most creative, versatile and perhaps also controversial German economists of the 20th century. The spectrum of his research covered legal issues and questions of business management and included the micro- and macroeconomics of closed and open economies.*

Stützel was an uncompromising champion of market principles without belonging to a particular school of thought. Many of his scientific insights



initially met with opposition, but they then became generally accepted as part of economic policy because they were built on a solid institutional order policy foundation, which Stützel developed with great consistency. His clarity of vision and his readiness to contradict, animated the academic debate and influenced the organisation of economic structures in Germany.

In his dissertation (1952), Stützel focused particularly on the phenomenon of economic power, which he attributed to the relationship between the value and the price of a commodity. One of his simplest and most memorable messages was the sentence: 'Paying and receiving market prices means protecting one's freedom and dignity'.

His post-doctoral thesis (1958) dealt with the 'balance mechanisms' of macroeconomic interactions. An important outcome of his analysis was that free loan conditions are necessary to keep a national economy solvent, i.e. a complete and liberalised banking system is required. In a report on German banking regulations ('Banking Policy – Today and Tomorrow', 1964), Stützel insisted on the complete removal of government regulations of debit and credit interest which were still in force during the early 1960s. One significant result of this study was the 'maximum load theory', which can be regarded as a forerunner of the 'value at risk' models.

Through being a member of the →*Council of Experts* for the Investigation of Economic Development (1966–1968), Stützel found himself in the crossfire of the heated debate about German exchange rate policy. In contrast to the majority of the council, Stützel supported strict adherence to the

fixed exchange rate system of Bretton Woods, which was in force at the time. Stützel resigned from the Council of Experts early, since he felt that the council's majority was restricting his views.

It is Stützel's great intellectual achievement that he recognised in the 1960s how unstable a system of flexible exchange rates would be. He pointed out that it was hardly likely that the adoption of flexible exchange rates would lead to greater financial autonomy, particularly in smaller countries.

In the 1970s, Stützel concentrated on an analysis of why, after the recession of 1974/75, →*unemployment* had gone up so much. He quickly understood that the problem was not so much economic as structural. He therefore argued in favour of a reduction of social welfare assistance (→*basic social security*) and of protection against unfair dismissal, as well as a complete re-organisation of the German social security system. Stützel gives an overview of these concepts in his book *Market Price and Human Dignity* (1981).

His contributions on the operational systems of banks are just as innovative – for example, those regarding the development of insider regulations and his commitment to the individual share certificate ('no-par share'), for the obligation to disclose secret reserves in the balance sheet and for an imputation system ('partner tax') in the corporation tax. Many of his innovations went into legislation, although the imputation system was later phased out with the 2001 tax reforms.

ACADEMIC CAREER: Doctorate 1952; post-doctoral lecturing qualification 1957; 1958–1987 professor at the University of Saarbrücken.

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Peter Bofinger

### Thielicke, Helmut

Born 4 December 1908

Died 5 March 1986

*The conservative protestant theologian Thielicke taught dogma and ethics – ultimately in Hamburg. He subscribes to neither the capitalist economy nor to →socialism. For Thielicke, there are no hybrids. Thielicke does not promote a God-given economic system; rather he feels it is our responsibility to organise the material aspects of the way we live. The competitive economy, which can be seen as a worldly structural law since it uses egoism as the driving force of human existence, has a specific ‘affinity for human nature’ (and is most suited to humans). This means that in human nature, God is pitching ‘the egoism of competition against the egoism of laziness’. The state has to be strong enough to be able to ensure that competition is based on performance. It has to intervene and control when →competition, which has a tendency to run to excess, starts to use the human need to earn a living as an ‘unrestrained driving force’ (Alexander →Rüstow) and an end in itself.*

*Thielicke was one of the few prominent Protestant-Lutheran theologians who sincerely concerned themselves with ethical and institutional problems in the economy. His*

*Theological Ethics deals with the competitive economy as a universal system.*

Thielicke’s ethics were based on the ‘Doctrine of Eons’ (theory of the ages). It teaches that man is in a state of continuity and discontinuity with this eon, the age between the creation of the world and its end. Continuity consists in the fact that we are subjected to the laws and systems of this world. God did not dissolve this eon; its ‘structural laws’ impose order on life. Christians, however, have been saved and are thus no longer subject to worldly powers. They live in Jesus Christ under the liberating grace of the gospel. This is where the aspect of discontinuity is expressed.

Thielicke places the Lutheran doctrine of justification, which describes this area of conflict, at the centre of his considerations. This doctrine sees man as sinning and righteous (saved) at the same time. The concept of the systems (orders) (politics, the state, economics, etc.) was borrowed from Lutheranism. For Thielicke, these function as organising emergency directives (from the time of creation until the end of the world). He saw them as protecting the world after the Fall. In his view, only family and marriage were conceived even before creation as ordering principles for the world.

In times when the inherent laws of the different spheres of life (‘practical constraints’) are interpreted as a superficial world view, the law is necessary as a constant warning (as a pointer to the provisional nature of the present age). For Thielicke, the economy serves the satisfaction of needs with its own inherent laws. He sees its theological and eth-

ical task in marking out a path for future acting. That means inherent laws of 'relative rank'. Christian theology and the Church will therefore only endorse an economic system which recognises this relative rank of the inherent laws and which is in tune with human nature. Both – in the form of Christian ethics – have to make the 'pitfalls of evil' visible.

For the state, the relative nature of the inherent laws means two things: having to police the market strictly; and having to implement a →social policy. This means that the state has the task of steering the economy between →liberalism (laissez-faire) and dirigism. Any other influence on the economy is unacceptable to Thielicke. Therefore he is also against any kind of →socialism/planned economy. In his positive attitude to the competitive economy, Thielicke comes close to Rüstow's thinking. But, for him, one thing is certain: any economy, however intact, is branded by the fallen eon.

ACADEMIC AND PROFESSIONAL CAREER: Thielicke was a disciple of the Lutheran theologian Paul Althaus in Erlangen and remained faithful to the Lutheranism which was practiced there without being committed to the political outlook of its teacher. During the Third Reich he was on the side of the Confessional Church. This is why he lost his temporary professorship in Heidelberg. After the war, he was professor of Systematic Theology and Ethics in Tübingen and Hamburg; he co-founded the Faculty of Theology in Hamburg and subsequently became rector of the University of Hamburg. It took him from 1943 until 1964 to write his *Theological Ethics*; the central part numbers over a 1,000 pages. He personally updated the two middle volumes just before his death. He was, in addition, a renowned preacher.

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THIELICKE, H. (1958ff.), *Theologische Ethik*, 4 vols, Tübingen; — (1968ff.), *Der Evangelische Glaube*, 3 vols, Tübingen.

Rolf Kramer

**Veit, Otto**

Born 29 December 1898

Died 31 January 1984

*Veit, the son of a general, is seen as one of the most outstanding post-Second World War currency and monetary theoreticians in the Federal Republic of Germany. He made an important contribution to the implementation of a stable financial and monetary constitutional framework and thus has helped to make the concept of the social market economy a reality. Beyond that, Veit had a great interest in philosophy and sociology and acquired a reputation as a universal scholar. The fact that he saw himself as a 'liberal' and was an active member of the Freiburg Ordo Circle, are proof that he must be counted among the architects of the social market economy. Veit had a reputation as an excellent writer and speaker, had a classical education and was respected for his strong and highly principled personality.*

Veit's academic publications primarily refer to currency and monetary policy and partly even pre-date his time at university. One of his most important works, *Real Theory of Money* (1966), was born out of ideas dating back to the final weeks of the war; it developed independently of the predominant monetary theory. Veit's interpretation of money as a commodity, which does not differ from other goods except in the degree of its liquidity, i.e. its power of disposal

over other goods, runs like a thread through his publications on monetary theory and justifies his independent position on liquidity theory.

In his compendium *Monetary Policy as the Art of the Impossible*, and in what was a standard work on monetary policy theory during the 1960s and 1970s, *Basic Outline of Currency Policy*, Veit processed the experiences from his time as president of the Hessen State central bank. In his books and essays, Veit is not only concerned with monetary theory and policy, but also with socio-cultural and philosophical topics. His key interest here is – as in the case of Walter →Eucken and Alexander →Rüstow – personal liberty, which he was keen to protect even during the National Socialist dictatorship. This also forms the basis of his economic theories.

In his main sociological work, *Sociology and Freedom*, published in 1957 as a revision of *The Escape from Freedom*, which had appeared 10 years before, Veit is discussing the danger of a loss of liberty as a result of ‘excessive material development’. Again and again, Veit is trying to find an explanation for the terrible events during National Socialism. His book *Christian-Jewish Coexistence*, which was published in 1965, is his attempt to prepare the ground for a harmonious coexistence in Germany.

ACADEMIC AND PROFESSIONAL CAREER: Having completed his military service as well as a degree in political economy and philosophy in Frankfurt, Veit in 1929 accepted a position as chief editor of *Industrie- und Handelszeitung* (*Journal for Industry and Commerce*) (subsequently *Nachrichten für den Außenhandel* (*Foreign Trade News*)). In 1934 he had to resign from his position for political reasons. After that, he

joined Hardy & Co. Bankers in Berlin, first as a business consultant, and later, until the end of the war, as managing director. His first monetary policy publications date back to this time, which is why it is not surprising that in 1946 he first became general manager of the *Nassauische Landesbank* (Nassau State Bank) in Wiesbaden and a year later was made president of the Hesse State Bank in Frankfurt. This also made him an *ex officio* member of the central bank council of the German States Bank, the predecessor of the →German Federal Bank (central bank). Veit was its acting chairman during the early months of its existence and he remained in his position at this nerve centre of currency and monetary policy in Germany until 1952, when he was appointed to the newly established Chair of Economic and Political Science (*Lehrstuhl für Wirtschaftliche Staatswissenschaften*), with a special emphasis on monetary and banking policy, at the Johann Wolfgang Goethe University in Frankfurt. At the same time he became director of the Institute for Banking Systems in Frankfurt, where he taught until his retirement in 1969. He was considered the grandseigneur of German monetary policy and, in his capacity as head of the supervisory board, he maintained his connection with the Issuing Bank even after he had become a university professor.

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VEIT, O. (1947), *Die Flucht vor der Freiheit: Versuch zur geschichtsphilosophischen Erhellung der Kulturkrise*, Frankfurt/M.; — (1948), *Die Volkswirtschaftliche Theorie der Liquidität*, Frankfurt/M.; — (1957), *Soziologie der Freiheit*, Frankfurt/M.; — (1961), *Grundriss der Währungspolitik*, Frankfurt/M.; — (1965), *Christlich-jüdische Koexistenz*, Frankfurt/M.; — (1968), *Währungspolitik als Kunst des Unmöglichen*, Frankfurt/M.; — (1966), *Reale Theorie des Geldes*, Tübingen.

Hans Jörg Thieme

**Welter, Erich**

Born 30 June 1900

Died 10 June 1982

*Welter tried all his life to familiarise non-economists with institutional order policy thinking, which entails thinking in terms of economic interconnectedness, couched in simple language accessible to everyone. His merit in his fight for a liberal order can hardly be exaggerated. His motto was: 'We cannot hope that the truth will gain the upper hand just because it is true. One has to fight for the truth.' Among the awards Welter received for his courageous journalism was the Great Order of Merit of the Federal Republic of Germany (1975), as well as the Ludwig Erhard Medal (1978).*

Welter was an academic, journalist and newspaper entrepreneur, and in each one of these roles he was equally committed to a liberal economic and social order. At a time when the →*social market economy* still had to prove its worth, and when a general strike was to force the resignation of Ludwig →*Erhard* from his office as Federal Minister of Economic Affairs, Welter, in close contact with Erhard, fought for the removal of the remnants of state control in the economy, for the →*Act Against Restraints of Competition*, for the liberalisation of foreign trade relations, for an independent central bank and for a stable currency. He also wanted the state to restrict itself to institutional order policy tasks, to withdraw from entrepreneurial activities, and to reduce →*interventionism*. In his view, the government had to behave like a consumer along the lines of a market economy. A large number of articles in the *Frankfurter Allgemeine Zeitung* dealt with these topics.

ACADEMIC CAREER: Doctorate in Berlin in 1921 (under Hermann Schumacher); post-doctoral qualification in Frankfurt in 1941 (under Wilhelm Gerloff); from 1944 assistant professor; from 1948 until his retirement in 1963 full professor of Economics at the University of Mainz; founder of the Research Institute for Economic Policy at the University of Mainz in 1950; 1949–1971, member of the Scientific Advisory Council at the Federal Transport Ministry; 1953–1975, member of the Research Advisory Council for German Reunification.

PROFESSIONAL CAREER: 1921 joins the editorial staff of the business section of the *Frankfurter Zeitung*; 1933–1934, editor-in-chief of the *Vösische Zeitung*, which was closed down due to pressure from the Nazis; 1934, returned to the *Frankfurter Zeitung*, where in 1943 he was promoted to deputy editor; in 1943, after the banning of the *Frankfurter Zeitung*, he became a reserve officer and 'scientific observer' in the Planning Department of the Ministry of Armament and War Industries; in 1946, he helped establish the *Wirtschaftszeitung* (trade journal) in Stuttgart (later the *Deutsche Zeitung und Wirtschaftszeitung*), from which Welter had to resign for reasons related to the legal regulations imposed by the occupying allied forces; in 1949 the *Frankfurter Allgemeine Zeitung* (FAZ) was established, with Welter remaining its chief editor and thinker until 1980.

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WELTER, E. (1954), *Falsch und richtig planen. Eine kritische Studie über die deutsche Wirtschaftslenkung im Zweiten Weltkrieg*, Heidelberg; — (1960), *Der Staat als Kunde. Öffentliche Aufträge in der Wettbewerbsordnung*, Heidelberg; — (1953), Die wirtschaftspolitische Bildungsaufgabe, in: Hunold, Albert (ed), *Wirtschaft ohne Wunder*, Erlenbach, Zurich, pp. 339ff.

Walter Hamm



## Themes

### Accident insurance

Compulsory Accident Insurance (AI) was first introduced under Bismarck in 1884 and was originally intended as a protection mainly for workers and employees in the industrial sector in the event of accidents in the workplace. Today the number of different functions of the AI has grown significantly in terms of both content and eligibility. The AI extends its cover to basically all workers and employees but also to farmers, people who work from home, entertainers, acrobats, artists and certain small business owners.

Also insured are prisoners who engage in work, lifesavers, blood donors and persons who give assistance at the scene of an accident, as well as those who help protect a person who has been unlawfully attacked and those who take part in the pursuit or arrest of a person suspected of a criminal act. The coverage also extends to children attending nursery schools, pupils attending day schools, learners during basic and advanced vocational training, honorary teachers and students during their undergraduate and postgraduate studies at university.

The commercial and agricultural employers' liability insurance associations, which are divided into professions and industries, and the respective government accident insurance bodies are responsible for the implementation of AI. The employers' liability insurance associations receive their funding via

employers' contributions. The level of these contributions depends on the salary of the insured employees and on the accident hazard categories to which the →enterprises are assigned on the basis of the frequency and extent of damages arising in the individual branches of an industry.

Measures for the prevention of industrial accidents are among the core tasks and services of the AI. Within their respective fields of competence, the employers' liability insurance associations are entitled to issue and enforce regulations for the prevention of accidents. In the event of an industrial accident, the AI provides services for the rehabilitation of the health of the injured parties, their reintegration into working life and, if necessary, financial compensation for them or for their survivors. The industrial accident must not be intentional, however, or be associated with a criminal act. The insurance cover extends not only to accidents in the workplace but to accidents which happen en route between the various workshops of an enterprise, on the way to work or on the way to the bank where the wages have been deposited by the employer.

Occupational diseases resulting from activities related to certain jobs – for example, contact with chemicals, radiation or infectious agents – are also classified as accidents in the workplace.

During the past decades, the reported number of industrial accidents and the number of fatal industrial accidents has gone down significantly, both in absolute terms and relative to the number of the workers employed. This positive trend must be partly attributed to the efforts of accident prevention and

partly to the increasing use of machinery for the execution of dangerous tasks.

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*Albrecht Bossert*

### Achievement principle

It is essential for every society that its members are motivated to perform, thereby attaining benefits for themselves and others. In the world at large, achievements for others usually attract public recognition and in most cases a reward. This applies regardless of the economic system.

In  $\rightarrow$ market economies, countless buyers are in  $\rightarrow$ competition with one another, evaluating the benefits they can derive from the achievements of competing sellers by offering a financial reward which they can pay, because they themselves have sold an achievement in the market which is useful to others. Both partners have to agree to this exchange and, to this extent, they have equal rights.

In hierarchical systems (government authorities, schools,  $\rightarrow$ enterprises), on the other hand, superiors, who do not have to be recipients of the achievement, evaluate the achievements of those who are subject to their judgment. There can be room for arbitrary decisions restricted by rules, controls or the possibility to escape into markets.

If in liberal systems those who have been evaluated can go to other evaluators and markets, they are protected from an arbitrary judgment.

In centrally managed economies, where the markets are not free, this escape route does not exist ( $\rightarrow$ socialism). It is true that the socialist principle may be valid: 'Everyone according to his abilities, for everyone according to his achievements.' Economic achievements, however, are only imperfectly assessed and rewarded depending on the extent to which politically motivated programmes are fulfilled. They are not very flexible and predominantly evaluate achievements according to technical standards.

The achievement principle is not perfect: markets are often imperfect; the value, particularly of immaterial achievements, is often only recognised too late or the achievements are never rewarded; and standards of evaluation change, just like objectives and value judgments.

Some see competition as a source of 'self exploitation' (neglect of relaxation and leisure time), liable to poison human relationships, particularly with one's competitors. The pursuit of the maximisation of profit and the avoidance of loss are supposed to be the result of a faulty evaluation of social priorities. A comprehensive assessment, however, depends largely on the way earned income is used. In addition, only one's own  $\rightarrow$ income and capital permits generosity, but it can be gained through anti-competitive behaviour, obstructing others and other privileges.

Competition leads to better and cheaper products and thus allows the results of one's own efforts to benefit



others. Only if achievements have yielded sufficient income and capital reserves, can social security benefits for those who are unable to achieve be financed. As long as the pressure to make financial contributions does not excessively weaken the will to achieve and achievement remains recognised, income distribution can be modified and taxes can be linked to the individual's ability to perform.

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*Hans Willgerodt*

## **Act Against Restraints of Competition**

Cartels and other restraints on competition have played a role for as long as there has been commercial activity. However, the implementation of comprehensive legal measures has been slow. The first German antitrust law worthy of the name was the Act Against Restraints of Competition (ARC) (1958). One of the key regulations of this law is the so-called monopolies prohibition of s. 1 of the ARC. The prohibition concerns horizontal restraints of competition, which apply between →enterprises on the same eco-

nomic level that are in →competition with one another. These include, above all, exceptionally damaging pricing and territorial agreements. Violations of this prohibition can be penalised with fines running into millions.

The trust prohibition is first of all complemented by evasion facts, in particular the recommendation prohibition (price recommendations). Secondly, the trust prohibition is limited by exemptions. Trusts that have been legalised based on exemption regulations are subject to abuse supervision by the →Federal Cartel Office.

The ARC also prohibits certain vertical restraints of trade, or those between a business and its suppliers or customers, such as manufacturers and wholesalers or retailers. The most problematical case is that of the retailer who is tied to a resale price by the manufacturer (retail price maintenance). Basically, only published items (such as books) are exempt from this prohibition.

The German antitrust law is not opposed to existing enterprises in dominant market positions in the form of monopolies or oligopolies or their emergence through internal growth, but it prohibits the abuse of such positions. This prohibition serves to prevent the abuse of behavioural leeway based on power, which cannot be effectively controlled by competition, but which harms competitors, higher or lower economic levels, and consumers. If the prohibition is violated, it can also be penalised with fines. In practice to date, the prohibition has never played an important role. The main reason for this is the difficulty of proving cases of abuse. The courts rightly insist on watertight proof.

The general prohibition of the abuse of market power is complemented by the discrimination prohibition, which has substantial practical significance. According to this rule, enterprises that dominate the market as well as certain other enterprises with relative market power are forbidden to obstruct other businesses wrongfully or to treat them inequitably without material justification.

The ARC makes provision for merger control (the control of company mergers) without authorising measures for the re-establishment of functional competition in markets that have become concentrated through internal growth or through past mergers. It can, however, prevent further structural deterioration due to mergers. For control purposes, mergers have to be registered with the Federal Cartel Office (FCO) prior to their execution if they

fulfil certain conditions. This specifically includes the condition that the enterprises involved must have had total international sales returns of at least €500,000.

The FCO has to veto mergers that would either establish or reinforce positions of market dominance. If, however, the enterprises involved can prove that their mergers would result in significantly improved competitive conditions, they can go ahead. A merger that has been vetoed by the FCO can be authorised by the Federal Minister of Economic Affairs if its competitive disadvantages are counterbalanced by overall economic benefits, or if it is overwhelmingly justified by being in the public interest. So far, the minister has rightly used this option only with great restraint.

Antitrust authorities in the legal sense are the FCO, the (federal) state

**Turnover in percent of the six largest companies in Germany in their respective industries, 2001–2004**

*Rate of concentration CR6*

	%	
	2001	2004
Mining, coal and lignite; extraction of peat	93.4	93.6
Extraction of crude petroleum and natural gas; service activities incidental to oil and gas extraction; excluding surveying	97.5	91.0
Manufacture of food products and beverages	9.9	8.2
Publishing, printing and reproduction of recorded media	10.7	11.0
Manufacture of chemicals and chemical products	26.4	22.8
Manufacture of basic metals	24.0	25.5
Manufacture of machinery and equipment	8.7	7.9
Manufacture of office machinery and computers	70.6	79.6
Manufacture of radio, television and communication equipment and apparatus	46.8	49.5
Manufacture of motor vehicles, trailers and semi-trailers	67.5	66.4
Recycling	48.6	50.3

*Source: Federal Cartel Office, 2007*

antitrust authorities and, for certain tasks, the Federal Minister of Economic Affairs, who is essentially responsible for the authorisation of mergers vetoed by the FCO. The competence allocation between the FCO and the national trust authorities – except for certain tasks which are the exclusive domain of the FCO (merger control) – depends on whether or not the effect of a restraint of competition goes beyond the borders of one of the states of the Federal Republic. If it goes beyond the Federal Republic, the European Commission has the competence to deal with larger mergers (→*EU: competition policy*).

The ARC is enforced by way of three categories of procedures, namely:

- regulatory offence procedure;
- administrative procedure; and
- civil procedure.

The first two are the domain of the trust authorities; in both categories the authorities have comprehensive rights of information and investigation. In civil proceedings, private entities that have sustained losses are entitled to claim compensation.

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Kurt Stockmann

## Agricultural policy

In almost every country, agricultural policy holds a special position within economic policy. A high degree of interference with the agricultural commodities markets by the state is common. In developing countries, agricultural produce prices are frequently kept below world market levels in order to make food more affordable for the poorer population groups. In the industrialised countries, however, the goal is to ensure that farmers earn a sufficient →*income*. There, agricultural produce prices are typically subsidised – often considerably – above the level at which free markets would be expected to settle. At the same time, in many industrialised countries substantial →*subsidies* are paid to the agricultural sector and the agricultural commodity markets are manipulated in various other ways (→*interventionism*).

The background for this protectionist bias of the agricultural policy in most industrialised countries is the fact that, in comparison with the overall economic growth rate, farmers' incomes have a tendency to remain below the income levels seen in other sectors of the economy. The reason for this lies in the specific nature of the development of →*supply and demand* on the agricultural commodities markets. The demand for food, and thus for agricultural produce, tends to grow more slowly than the overall economic revenue, since food represents saturation goods: the income elasticity of the demand for food is small.

This is expressed in Engel's Law (named after the Prussian statistician Ernst Engel). When consumer income

rises by one per cent, the demand for agricultural produce rises by significantly less than one per cent. Simultaneously, however, productivity levels in agriculture go up more (e.g. due to increased yields in plant and animal production), than the national economic average. This is why the supply of agricultural produce on offer grows particularly fast. Thus, the rapidly rising supply to the agricultural commodity markets is met by a level of demand which grows much more slowly. The consequence is that food prices tend to decrease (or rather: are trailing behind the price development of other goods). This puts farmers' income levels under pressure.

In reaction to this pressure on income levels, the number of persons employed in the agricultural sector continues to go down. In Germany (the former federal territory) in around 1950 for instance, there were still about five million people employed in the agricultural sector. Today, this number has shrunk to just over 700,000 (today's federal territory). Other industrialised countries have experienced a similar trend.

This move away from agriculture and the underlying financial pressures are naturally accompanied by social problems. The extensive assistance set aside by the agricultural policy-makers for the farming sector is a manifestation of the desire to alleviate these social problems by means of economic policy. While this desire is politically laudable, from an economic point of view the choice of instruments which were traditionally used by agricultural policy-makers is unsatisfactory.

Essentially, these instruments were aimed at combating the downward

trend of agricultural produce prices. This was achieved mainly through tariffs and similar measures, which made goods imported from abroad more expensive while exports were supported by subsidies and, on the domestic market, agricultural products received subsidies too. Market signals were thereby rendered ineffectual. In many cases, a surplus of agricultural produce resulted, which would initially be left in government storage (transitional storage). Subsequently, however, it was propped up by subsidies and dumped on the global marketplace or it was at times even destroyed.

If the world markets ran out of capacity or funding for the surplus removal, supply would in some cases be restricted by means of quotas (quantity limitations) imposed on individual farmers, or by the administratively enforced cessation of farming activities in certain areas. The main political objective was thus to keep domestic agricultural produce prices higher than they would have been had market forces been given free rein.

This particular preoccupation with agricultural policy was, however, extremely problematical for two reasons. First, the most difficult dilemma in the farming sector – a continuously growing supply faced with a small increase in demand – could not really be solved in this manner. It is true that national agricultural policy-makers could, by subsidising agricultural products, make domestic farmers believe that the demand for their products was high. But it is obvious that, internationally, it was impossible to increase overall demand using the same method. In the final analysis, each country tried through its

respective agricultural policy to secure a market for its own farmers, which, as a result, was lost to the farmers from other countries. Accordingly, this agricultural policy, which was deployed by nearly all industrialised countries to similar effect, led to ever more deeply entrenched commercial conflicts.

Second, the policy of agricultural subsidies was not implemented where it was needed most, i.e. at the social problems it was supposed to alleviate. Direct grants to farmers (transfers) could have achieved this without rendering market forces powerless. But the agricultural policy-makers resisted this political alternative for a long time since it was feared that this type of agricultural subsidy could make the system more transparent and thus politically more susceptible.

Several years ago, however, a worldwide reorientation in the sphere of agricultural policy started, and many countries began to reshape their agricultural policy. At the international level, this was entrenched through the new agricultural trade rules, which were agreed during the General Agreement on Tariffs and Trade (GATT) negotiations held in Uruguay (1986–1994) (*→international organisations*). It was hoped that this would appease the violent conflicts in the international agricultural trade arena.

At the national level, more and more countries have started to reduce interference with the agricultural commodities markets and instead to subsidise agricultural incomes by means of direct grants (*→EU: agricultural policy*). Thus, at present, agricultural policy worldwide is setting its sights on new horizons.

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### Balance of payments equilibrium

The legal basis for the goal of ‘balance of payments equilibrium’ is the 1967 Act to Promote Economic Stability and Growth (*Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft [StabG]*).

Section 1 *StabG* specifies that through their economic and monetary policy decisions, the federal government and the federal states have to help sustain macroeconomic balance. They are to act in such a way that, in the context of a market economy, the objectives of *→price level stability*, a high level of *→employment*, constant and appropriate economic growth and a balance of payments equilibrium are realised. Since these four goals cannot be realised at the same time, one refers to it as the so-called magic square.

Even if at the beginning of the 21st century the Keynesian concept of stabilisation (*→Keynesianism*) – which was dominant at the time of the introduction of the *StabG* – has ceased to be the prevalent economic policy model, the *StabG* is still in force and unchanged to this day.

While, on the one hand, the balance of payments equilibrium is supposed to neutralise existing instabilities in the global economy, internal economic pol-

icy measures on the other hand are aimed at stabilising the domestic economy and must not be put at risk by the effects of foreign economic instability.

A definition of the balance of payments equilibrium is difficult and controversial. Many regard it as realised when the balance of payments is equal to the balance of international movements of capital. However, depending on the economic policy orientation, it is also possible to aspire to the equalisation of other components of the balance of payments.

In its annual reports, the federal government defines the objective 'balance of payments equilibrium' as the percentage share of the foreign contribution (export minus import of goods and services) in the nominal gross domestic product (GDP) (= sum of all domestically produced and evaluated goods and services).

In the past, a surplus of between 0.5% and 0.9% of the GDP was envisaged. A comparison of the goal values with the actual data shows, however, that this objective was only rarely achieved. In the present system of free international exchange of goods and services and of flexible exchange rates, the aim of a balance of payments equilibrium is difficult to achieve.

This is because the target variable, determined by the federal government as the external balance, is not easily influenced by economic policy actions since foreign demand escapes any direct control and since restrictions on foreign trade do not fit into a liberal system of international trade ( $\rightarrow$ world trade order).

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### Banking system, structure and supervision

The balancing of liquidity, which is one of the functions of financial institutions, helps to overcome frictions in the monetary flow of a national economy. The seller and the potential buyer of capital may be in different locations, and their preferences regarding the amount, the term and the risk category of the investment and/or loan may differ.

Financial institutions justify their existence by bringing buyers and sellers of capital together indirectly, as financial intermediaries (finance middlemen), and more cost-effectively than this would be possible in the case of a direct contact. In the context of 'classical' deposit or credit transactions (commercial banking), they offer to undertake the transfer of cash amounts and to transform the terms, volumes and risks involved.

In dealing with the capital surplus and deficits of an economy, this can lower the costs of identifying contractual partners while at the same time making it cheaper to initiate, sign, implement and monitor agreements.

Typical of the German economy is the universal banking system. Contrary to the situation in the United States where until 1999 banks were subject to government regulations, forcing them

to specialise in certain types of business (separation banking system), Germany knows no restrictions on the choice of products banks are allowed to offer.

Regardless of this, however, and depending on the respective legal framework, a distinction must be made between several different sectors of the banking system.

All four major banks with their supra-regional branch networks (Deutsche Bank, Bayerische Hypo- und Vereinsbank, Dresdner Bank and Commerzbank), as well as certain private banks, take the form of public limited companies. Over the past several decades, the major banks have expanded their foreign business significantly and successfully and now rank among the top financial institutions in the world in the sectors of executive level and standardised private customer business (but due to the legal restructuring of private pension schemes increasingly in competition with the insurance industry), and in the financing of large industrial and commercial companies as well as medium-sized companies.

The savings banks, on the other hand, are under public responsibility and do business in (single or several) cities and/or districts. Since this means that the scope of their business activities is geographically limited. There are also the regional banks which are the property of either one or more German federal states, as well as the regional associations of the savings banks. In terms of the subsidiarity principle, they are supposed to deal with those transactions for which individual savings banks lack the requisite size or know-how (e.g. foreign business). The leading institution of the organisation is the DGZ

Deka Bank, which specialises in payment transactions and bond investments.

Considered together, these specialised institutions – which adhere to the same legal framework as insurance or capital investment companies and building societies – become a recognisable group of bodies of the public law, structurally similar to the major banks with their headquarters in Frankfurt and their branches spread out all over Germany. Differently from the major banks, however, they function in a decentralised manner and are made up of independent enterprises. Unlike private banks, though, the institutions of this sector are expressly not pursuing the goal of profit maximisation.

According to the legal regulations which apply at regional level, they have been officially appointed to protect the ‘public interest’ by ensuring that the loan requirements of the economically weaker population groups as well as the middle class are dealt with, and at the same time playing a balancing role with respect to regional policy and also stimulating → *competition* in the banking system. While there are opinions questioning strongly the involvement of local government in these matters, European directives that came into force in 2005 require the regional and savings banks to do without their liability guarantee from the state or the municipality.

The third important sector includes the community and Raiffeisen banks, which are organised along the lines of cooperatives. In contrast to the focus on public interest, cooperatives – which originally started as self-help groups and where only the members of the cooperative could also be customers –

pursue a promotional task. Today, this has actually come to mean that the distribution of their operating profit among the members of the cooperative has become the priority. Their traditional target groups were above all the private clients wanting to execute so-called bulk transactions, as well as business clients from commerce, the trades, small business and agriculture.

In the same way as official institutions, this sector forms a grouping consisting of the major cooperatives and one leading institute (the DZ Bank); however, as a consequence of structural crises in the organisation, the intermediate level of the central bank, which is comparable to the regional banks, has shrunk and there is only one institution left (the WGZ Bank). Apart from that, there are insurance companies, building societies and savings and investment enterprises which are comparable due to the fact that the credit cooperatives operate in geographically limited areas of business.

Apart from these three large sectors relevant to the banking system, there are several smaller groupings, mostly specialising in certain types of business. Among these are: the distinguished old private banking houses, which traditionally look after the capital investments of a select number of private clients and which deal with complex corporate finance issues; the mortgage banks and building societies with their emphasis on real estate financing; foreign banks; and also the recently established banking arms of industrial commercial companies (e.g. VW Bank, Quelle Bank).

Particularly due to technical progress and international integration

(→*globalisation*), the competitive pressure on the banking system in Germany has also increased. Thus traditional commercial banking is being put under increasing pressure by investment banking, which is all about stocks and shares – either for the financial investments of private households (e.g. in the form of shares as an alternative to savings deposits) or for corporate finance (e.g. the replacement of traditional bank credits by bonds) (→*capital markets*).

Besides technical advances (the sale of financial services over the internet), this preference for documented financing (securitisation) has contributed greatly to the wave of increased concentration of the banking system in Germany. Since 1970 when there were more than 8,000 independent banking institutions, the numbers declined to just over 5,000 in 1980, to 4,500 in 1990 and to as few as about 2,300 in 2003. Indeed, the years 2002 and 2003 were the darkest in the history of German banking since 1945. The simultaneous occurrence of a destabilisation of the economy and a crisis on the stock exchange led to a financial decline and the loss of 50,000 jobs in the banking sector.

As in the case of the insurance industry, government regulations leave the banking system much less room for manoeuvre than other industries. The reason for this has been attributed to the fact that trustworthiness is a specifically sensitive issue for banks. Particularly for economically less enlightened small-time investors – so the argument goes – vague rumours about a bank being in financial difficulties are enough to make them withdraw their deposits. This could trigger a rush for a



place at the front of the queue in the bank ('run'), which would eat up the liquidity of that bank. As a result, the institution could be forced to call up funds from other banks, thereby gradually causing problems for the entire banking system (domino effect). Eventually, the financial system as a whole could be plunged into a crisis, which could lead to the loss of the retirement savings of large sections of the population, but equally the credit supply of the entire economy might be brought to a halt.

Since such nightmarish crisis situations can never be completely excluded, state interference with the economic process is considered justified (→*interventionism*). Through the German Banking Act, the state puts banks under an obligation to keep financial reserves in the form of 'own capital funds' for the compensation of losses. These funds must be in proportion to the banks' exposure (e.g. borrowers' default, the exchange rate or fluctuating share prices or interest rates). The observation of these and other rules for the handling of risks is supervised by the Federal Financial Supervisory Authority (→*supervisory offices*) in cooperation with the →*German Federal Bank* as the 'bank of the banks'.

At present, banking regulations are undergoing an unprecedented restructuring process. The Basel Committee on Banking Supervision – a committee comprising the financial controllers from the major industrial nations – is planning to allow financial institutions to consult their own risk management and rating systems for the calculation of the amount of own capital funds they require. This would replace the previ-

ously rigid instructions from the financial supervisors, which were not linked to the specific risk profiles of the various banks. They do reserve the right, however, to undertake detailed, regular, local controls of the system (qualitative supervision). In addition, Basel II stipulates more detailed written communications from the banks.

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### Basic rights, the Basic Law and social market economy

The German Basic Law (*Grundgesetz*) (constitution) formally permits any type of economic system provided it abides by the Basic Law, in particular the fundamental rights. The fundamental rights – freedom of action, equality before the law, freedom of association, freedom of movement, the freedom to choose and carry out an occupation and the right to own and dispose of private property and also the means of production – are incompatible with a fully evolved and permanent central administration economy (→*socialism/planned economy*), which requires that complex economic tasks and rights have to be assigned according to a central plan. For the sake of this

plan, associations of independent economic interest groups, which include free trade unions, and the free choice of place of residence and occupation, have to be suppressed.

This system is therefore a form of political dictatorship that generally does not grant freedom of opinion. Only a →*market economy* can guarantee the fundamental rights which safeguard freedom. The Basic Law is therefore not politically and economically neutral. The prescription of an 'open market economy with free competition' effectively represents the →*European Union* constitutional provisions, with the consequence that the formal neutrality of the constitution has been repealed.

At the same time, the Basic Law prescribes a constitutional state under the Rule of Law (Article 28 (1)), which (because of Article 20(1)) has often been abbreviated to a social state (→*social state and welfare state*). This can be interpreted as governmental adjustments of rights and data which influence market processes, as well as social and political alliances and redistributions of →*income and capital*. The Basic Law thus encapsulates the two components of the →*social market economy*, i.e. a free and competitive market and social security.

In relation to privileges and anti-competition restrictions, the open market naturally includes certain helpful elements, such as performance results which are passed on in the form of lower prices, better product quality and higher net compensation, as well as offering career advancement opportunities which do not exist in closed systems. The →*basic social security* policy is able to protect those from hardship who are not, not yet or no longer

engaged in gainful employment, and it can do the same for those who have become victims of →*competition* or who are out of work. It can also promote the integration of individuals who are able to work, open up opportunities offered by the education system and ensure that the consequences of government interventions on the specific situation of those involved are taken into consideration.

In certain cases, however, the contemporary social security and regulation state does protect the privileges of, for example, specific industries (agriculture, coal mining) and the owners of jobs and housing, endangering both the state under the rule of law and the market economy through short-term legislation and interventions which do not conform with the system. Frequently, social fundamental rights translate into claims for free services of a social or financial nature, for which, in a market economy, the state under the rule of law should either not be at all responsible or only partially responsible (full employment, jobs, education, housing and income). Thus, more social security for some comes at the price of greater uncertainty for others (e.g. taxpayers).

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## Basic social security

Basic social security is considered as the ultimate safety net of the social security system. The overall aim of basic social security is to protect all members of society against poverty and hardship and to enable everyone to lead a dignified life. The intention is to enable the beneficiaries of these services to live independently of assistance where possible.

The basic social security system is summed up in the different volumes of the Social Security Code and includes the Basic Social Services for Job-seekers (Social Security Code II), Social Assistance (Social Security Code XII) and the Asylum-Seekers' Benefits Act. All the basic social security services are public assistance, i.e. the allocation of the services presupposes need, and any legal claim for these services has to be justified. The type and level of the service depends on the individual case. The funds come from general government tax revenue.

Persons capable of gainful employment but in need of assistance are entitled to basic social security benefits for job-seekers, while the same applies to persons living with entitled individuals in a shared household. Persons between the ages of 15 and 65 are considered employable, unless they are incapable, due to illness or handicap, to be gainfully employed for a minimum of three hours daily under the normal conditions of the general job market.

The primary purpose of basic social security for job-seekers is to reintegrate the unemployed person into a working life, but the beneficiary of the services is expected to show active participation.

The services available under the Social Security Code II consist of services aimed at securing work, and of cash payments to cover living expenses. Apart from the general services for job creation, according to the Social Security Code III, is assistance for the support of dependants who are under age or in need of care, as well as counselling for debt, addiction and psychosocial problems.

In all states, persons capable of gainful employment but in need of assistance receive normal benefits of €347 (since July 2007). The costs for appropriate housing and heating as well as supplementary benefits for single parents and handicapped persons are extra. The regular amounts are adjusted on the basis of the government pension contributions, i.e. they are index-linked. Recipients of assistance who were previously in receipt of unemployment pay receive an additional amount of €160 (€320 with partners) plus €60 for each child, for a maximum of two years. After the first year, this additional amount is reduced by around 50%. This is supposed to encourage the unemployed person to take the initiative and find new employment. The financial incentive is increased further by certain allowances which do not feature in the final income account.

Persons incapable of gainful employment who live in a shared household with persons entitled to claims, are entitled to public welfare benefits. Up to the age of 14, the public welfare benefit equals 60%, and from the age of 15 up to a maximum of 25 years it increases to 80% of the regular amount, as long as the children live at home and do not work.

Persons in need of assistance who are not employable or who cannot reasonably be expected to take up gainful employment, are entitled to public assistance in terms of Volume XII of the Social Security Code. It is considered unreasonable for a person to have to take up gainful employment if a child of less than three years of age has to be cared for, or if the care of a family member would be compromised.

Public assistance includes seven different types of service; the more important of these are supplementary payments to cover living expenses, basic social security for the aged and, in the event of reduced earning capacity, assisting handicapped individuals to become integrated, and assistance with nursing care. The services are calculated on standard regular rates which are specified by ordinance of the federal state.

In July 2003 the basic rate per person amounted to between €297 (Baden-Württemberg and Hessen) and €282 (Thuringia, Saxony and Mecklenburg-Western Pomerania). Every five years, the standard regular rates are adjusted to the empirically determined consumer habits of the lower-income brackets (statistical model). Besides the standard regular rate, social security also covers the cost of accommodation and heating. For certain groups of people, such as single parents, the elderly, pregnant women and the disabled, lump-sum supplements of 17–36% of the basic regular rate are planned; for valid reasons, higher amounts of supplementary payments can be granted.

Prior to being awarded public assistance, the recipient has to disclose his or her total income and all assets. This also applies to alimony claims from a third

party, which are generally passed on to social security. Persons over 65 years of age and persons with severely reduced earning capacity are exempted from this rule, and alimony claims from their children and parents are not considered, provided that the total annual income of the persons claiming social security does not exceed €100,000. This extremely generous income limit is intended to prevent an existing need for social security being concealed for fear of recourse by social security authorities to close family members (so-called covert or ashamed → *poverty*).

Social services for foreign refugees occupy a special place within the basic social security system. Since 1 November 1993, social security services for asylum-seekers have been replaced by services offered in terms of the Asylum-Seekers' Benefits Act.

By comparison with social security, the entitlements of asylum-seekers are clearly reduced. For the first three years, these are basically supposed to take the form of services in kind. For the duration of the asylum proceedings, the basic services provide the necessary food, accommodation, clothing and health care.

The monetary value of the basic services is €184 for the head of the household, and for members of the household up to the age of 7, €112, and for household members from the age of 8 it is €158. These rates have been unchanged since the introduction of the Asylum-Seekers' Benefits Act.

The introduction of basic public social security for job-seekers and the revised public social security system in the Social Security Act XII (Social Security Code XII) are better suited to

the complex situation of the recipients of assistance than was the old Federal Public Assistance Act. The Unemployment Pay II for persons capable of gainful employment but in need of assistance constitutes a social security service, which was clearly designed according to the principle of encouragement and demand.

The Social Security Act II combines financial incentives for the acceptance of a new job with significant penalties in the event that work which has been offered is not taken. Persons incapable of gainful employment and a closely defined circle of persons who cannot reasonably be expected to take on gainful employment, receive assistance according to the revised version of the Public Assistance Act. This means that public social security is obliged to assist only in certain exceptional cases specified in the Act, but otherwise it has largely been relieved of the cost of unemployment.

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**Business accountancy:  
Basic concepts**

Accounting as a subsection of business management is understood as the numerical illustration of economic facts at a specific point in time. For the description and demarcation of stocks, debts, equity capital, etc., certain terms

have been defined, some of which are also colloquially used. There are four distinct concepts in accountancy:

***Deposits and disbursements***

Each procedure which adds to the liquidity of a business (cash in hand, assets in financial institutions, cheques, etc.) is considered as a deposit, while each procedure which leads to a reduction of liquidity is called a disbursement. The difference between deposits and disbursements is called payment surplus and/or cash flow. This basic mathematical system forms the basis of investment and finance calculation.

*Example:* A company sells a product to the value of €10,000 to a customer, who pays cash instantly. The liquid means have increased, meaning that a deposit of the value of €10,000 has been made.

***Receipts and expenses***

Receipts designate the financial value of goods and services sold, while expenses designate the financial value of goods and services received. Thus receipts (expenses) are present if the financial resources (liquid means plus receivables minus liabilities) are increased (decreased) by means of a business transaction. The difference between receipts and expenses is called financial balance.

*Example:* A company sells goods to the value of €10,000 on 1 June which the customer receives and has to pay for by 1 July. On 1 June no deposit takes place, since the liquid means have not yet increased. The company, however, already has a claim against the customer on 1 June, so that a receipt of €10,000 is present.

**Revenue and expenditure**

These represent the assessed goods production and/or the assessed goods consumption by the company within one accounting period (financial year). A revenue is present if actual assets, i.e. the sum of financial resources and material property (e.g. stocks, machines, securities, etc.) increase. In Germany, revenues comprise all increases of the company's shareholders' equity, while expenditures comprise all reductions of a company's shareholders' equity. The balance of revenue and expenditures is called an annual surplus or an annual deficit.

The two terms relate to the date of consumption of goods and/or the production of goods. By contrast, the deposit disbursement calculation refers to the date of payment for goods received and/or to the payment receipt for goods supplied.

The receipts/expenses account relates to the date of purchase of goods and/or the supply of goods.

*Example:* The company sells goods, which the accountants have valued at €8,000, for €10,000. A receipt at a value of €10,000 develops. An increase of the financial resources to the amount of €8,000 takes place, but no increase in net assets because an equal reduction of the material property occurs.

Only the difference between the higher selling price and the book value represents a receipt and a revenue exceeding the existing expenditure, and thus an actual increase of net assets at a value of €2,000.

The , required by the rules of commercial law, is based on these calculations. It has to be drawn up by companies in Germany and must follow cer-

tain legal stipulations, in particular the accounting regulations of the code of commercial law. Since company outsiders (e.g. suppliers, banks, shareholders, the tax office) are also permitted access to the annual report, its compilation is considered part of the external accounting system.

**Proceeds (performance) and costs**

Contrary to the pairs of terms described so far, which are predominantly used in the external accounting system, proceeds and costs form the basis of costing and performance calculations. The costing and performance calculations are part of the internal accounting system, which is not legally regulated and can thus be tailored to the company's individual needs, while generally not being accessible to outsiders. Performance represents the assessed value of goods produced by the company during a certain period, costs represent the assessed value of goods consumed, while the balance is called the operating result. Proceeds and revenue as well as expenditure and costs do not correspond entirely. This is made particularly clear with reference to so-called calculated costs which commonly form part of cost calculations. Costs which are not offset by an equal expenditure or an expenditure of a different amount are called calculated costs, because they are calculated particularly for costing and performance calculations.

One differentiates between calculated write-offs, calculated interest, calculated entrepreneurial salary, calculated venture cost and calculated rent.

*Example:* Calculated interest is the interest which the capital tied up in the running of the business would have

yielded from an alternative investment. Not only interest on loan capital, which must be paid, for example, for credits, is taken into account, but also fictitious interest for equity capital. While a company's equity capital does not actually cost interest, it nevertheless represents a loss of benefit when it does not yield interest since it could be profitably invested elsewhere (alternative costs, opportunity costs).

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## Business cycles

Economic fluctuations are waves that affect the economy as a whole (according to Gottfried Haberler, 1937). The statistically observable development of macroeconomic activities is usually made visible in the altered positive/negative fluctuations of the gross national product (GNP), the gross domestic product (GDP) (→*circular flow of incomes, national income and national product*), as well as the rate of utilisation of the production capacities. However, these indicators are not the only parameters with which economic →*growth* and its cyclic development are explained. Several processes, all of them

controversial, are supposed to assist the subdivision of the elements (growth/business cycle), which is didactically and methodically necessary.

In the history of economic theory, abstract representations of economic cycles of uniform shape and duration played an important role: for example the division into the four phases of recession, recovery, boom and downturn, as well as the representation of three Kitchin cycles (3.5–4 years) as one Juglar cycle (7–11 years) and of six Juglar cycles as a Kondratieff cycle (50–60 years).

More recent market research concentrates on the identification of recurring patterns and temporal as well as causal relationships within and between macroeconomic entities. Particularly the construction and application of statistical indicators which appear before, with and after the GDP as key reference values (e.g. orders received, utilisation of capacity, unemployment levels) are selected in order to examine whether there is a (self-replicating) pattern between the economic parameters. If there is, then these relationships can be distilled into a theory of business cycles, which can be used for empirical diagnoses, prognoses and (quantitative) recommendations for an effective and appropriate economic stabilisation policy.

This sort of statistical agreement (concordance) inevitably takes the definitions of the concept of business cycles as its point of departure:

- Business cycles are the periodic ebb and flow of growth rates of the gross national income in real terms or the GDP. A modern representation of

Haberler's concept of the wave-like movement of the economy would be referred to as a growth cycle.

- Business cycles are more or less regular deviations from an equilibrium growth rate, which is equated with the statistical trend of the growth rates (see the above division of the elements into growth and business cycle).
- Business cycles are the assumed difference between the growth rate of the estimated production potential and the growth rate of the actual demand (gross national income plus imported goods). One is looking at a period of economic recovery if the potential growth rate is smaller than the demand increase. A period of economic downturn is characterised by a rate of potential growth that exceeds the demand increase.
- Business cycles are the ups and downs in the rate of utilisation of the estimated overall economic production potential.

Since the Federal Republic of Germany came into existence, cycles of four to five years' duration – of which two were years with an economic upward trend and three were years of economic downturn – could be identified along the lines of the first point, although there are exceptions to this rule.

Theories on business cycles that are supposed to explain the empirically determined ups and downs differ depending on their basic scientific structure, which either belongs to the

(neo)-→*Keynesian* School (see the multiplier-accelerator models according to Paul A. Samuelson [born 1915] or John R. Hicks [1904–1989]). But there are also the theories of the (neo-)classical period (real business cycle theory).

An alternative categorisation subdivides the models of business cycle theory depending on whether they include the real macroeconomic sector of the economy only, or both the real and the monetary sectors (potential production volume during times of utilisation to capacity). Regarding the purely real sector of the economy, the question is whether the commodity market exclusively is considered or both the commodity and service markets.

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### **Business cycle policy**

Economic stabilisation policy or business cycle policy is a form of process policy that takes place within a specific (usually national) framework of economic order (→*institutional order policy and process policy*). It requires empirically sound knowledge of business cycle theory for a specific country and a specific period in time in order to influence the



economic activity in both the short- and medium-term.

The main goal is the stabilisation of macroeconomic variables whose excessive fluctuations would be seen as endangering welfare and social freedom. The preservation of economic →*growth* as well as the avoidance of inflation and cyclical unemployment are among the macroeconomic variables and thus also the object of macroeconomic goals. These and other goals are politically determined and therefore exogenous to 'macroeconomic balance'.

Based on the fact that the individual goals often contradict one another (trade-off) – meaning that they cannot all be realised at once – one speaks of a magic square. Therefore, the immediate economic policy implementation requires consideration of the objectives.

The business cycle policy-makers are usually the state (→*fiscal federalism*) and/or the central banks (→*monetarism*). When a problem is registered, the instruments of monetary policy can adapt to the current situation at their discretion and can, depending on the aims of the economic policy-makers and the legal circumstances, be implemented or be subject to predetermined regulations. Business cycle policy measures are automatically selected and implemented in doses according to predetermined regulations.

The state has the option to stabilise the macroeconomic demand anti-cyclically with business cycle policy, such as spending programmes, or with the help of a skilfully constructed fiscal system by structuring the contribution amounts of the general public according to the cyclical circumstances (tax reductions when demand and trade

cycles are weak, tax increases when trade cycles and demand are booming).

The economic stabilisation policy instrument of the central bank refers to the expansive or contractive regulation of the money supply by adjusting the central bank discount rate through open market operations or a compulsory minimum reserve.

Most recently, economic stabilisation inactivity is enjoying renewed popularity (economically neutral budget, *laissez-faire*, →*liberalism*). Besides confidence in the self-regulating mechanism of the market – reinforced in some cases by the reliance on corresponding efficiency enhancing interventions (→*interventionism*) – the lag structure also justifies economic measures that exercise just such a restraint towards an active state economic stabilisation policy. (Between the recognition of a problem and the time where a decision on what is to be done can be made, there is a time-lag between when the measure has been implemented and when the effects can be felt.)

The required knowledge of the causal and temporal consequence correlations between instruments and goal variables for an effective economic stabilisation policy is documented in macroeconomic models, which make it possible to judge the planned measures based on statistical and dynamic multipliers in a simulation. This implies that these models are realistic and that the structure as well as the developmental direction of a national economy is documented appropriately. The business cycle policy-maker's real workday, however, does not meet these requirements: one has to be happy with vague images of the economy and to

make decisions based on hypothetical rough structures. Thus, modesty is the real virtue of business cycle policy.

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## Capital markets

The capital market is the place where the supplier and the potential buyer of available capital meet. Macroeconomically, the task of the capital market is the coordination of the individual investment and finance plans of the economic agents. On the one hand, the intention is to put the capital to the most profitable use possible while, on the other hand, material investments are supposed to be made with the most suitable type of funding (allocation function), in order to maximise the prosperity of all members of society.

The capital market, just like the financial institutions, plays a transformational role. The capital which flows from many smaller sources is pooled. The large amount of collected capital makes it possible to lend even short-term capital on a long-term basis; i.e. the commitment periods of the financial sources and the recipients are not linked.

This collecting function and period transformation function are utilised by the financial institutions too. Risks are also spread out (diversified) and balanced, while at the same time any information gradient between the market participants is levelled out. These transformational steps will take place in the capital market, however, only if they are more profitable there than through a financial intermediary, such as a bank. The different types of market organisation and the associated costs – for example, for the provision of information and processing as well as the trading of financial products – therefore play an important role.

Frequently, the term capital market is used for the longer-term segments of the investment and/or procurement of funds in the form of (above all) shares and loans. Conceptually, a distinction must be made between the (short-term) money market and the so-called credit market (for the agreement of more individualised, non-tradable financial contracts with banks, insurance companies, etc.).

A share is a document that confirms ownership of a portion of an enterprise. The money paid to the enterprise through the issue (emission) in the primary market is put at its disposal for an unlimited length of time. Independently of that, the owners of the share can trade it on, for example, a stock exchange – the so-called secondary market – which means that they own a piece of paper which can be liquidated quite easily (i.e. be transformed into liquid means). Its claim to proceeds (dividends) is variable insofar as it depends on the profit which was earned and distributed by the relevant enter-

prise. This means that there is a chance of receiving high dividends while the enterprise is doing well. On the other hand, the investor runs the risk – and this makes a share a risky piece of paper – that when times are bad no dividend is paid and, in addition, the share price can go down.

These dangers, however, have to be weighed against the opportunity to influence the destiny of the enterprise, which can be utilised in the context of the annual general meeting. But only a few shareholders make use of this option. They can delegate their right to vote to, for example, a financial institution where they keep their deposit of securities.

Since the mid-1990s, the financing of enterprises through the stock markets has increased markedly in Germany. While not even 20 new companies were listed in 1996, the number of companies issuing shares for the first time rose to 170 in 1999 and 130 in 2000, with the new share value totalling some €5 billion in 1999 and €3.6 billion in 2000. Thus in Germany, the market for share capital (or venture capital), which was still in its infancy a few years ago, is beginning to catch up with developments in the rest of the world. This is helped by a greater readiness of private investors to add shares to their portfolio. This in turn came about through a number of large, high-profile share issues by former →*public enterprises* (Telecom, the Post Office); this is further enhanced by the fact that larger strata of society are economically better informed, and by a changed attitude to risk-taking within the ‘generation of heirs’.

By the end of 2002, for example, more than 5% of direct investments in

private portfolios was represented by shares, with an added 2% through funds; while between 1988 and 2000 the number of shareholders rose from 3.2 million to 6.2 million, meaning that in 2000 one in 10 of all those older than 14 owned shares. These record numbers have since declined somewhat – with the German stock market having lost half of its value between 2000 and 2004. The number of shareholders in 2006 was 4.24 million.

The buying and selling of shares through the stock exchange takes place in different segments. The shares with the highest turnover are quoted in the official trade; its development is reflected in the DAX (German share index); the so-called price formation and/or signal function of the stock exchange. The new market segment for the new, technology-based companies had to be closed down after a share price collapse, mainly due to criminal activities in individual companies. Since that time – depending on the extent of information published by the →*entrepreneurs* – a distinction is made between prime and general standard.

While an enterprise gains access to shareholders’ equity (or its own capital funds) by issuing shares, it can raise loan capital by issuing bonds (obligations, debentures). They basically have the same characteristics as bank loans but, unlike these, they can be traded on the stock exchange. They document the right of the creditor to repayment of the capital amount borrowed by the enterprise at the time of issue, inclusive of interest at a rate which is not linked to the company profit. This interest falls due prior to the distribution of possible dividends so that from the investor’s

point of view, bonds have to be regarded as less risky than shares.

Besides that, the capital is only made available for a limited period. The bond owner is not entitled to get involved in the company's management as, unlike the shareholder, he does not become a joint owner.

In 2002, the circulation of securities at fixed interest rates (annuities) as the most important segment of the bond market, amounted to €2.5 billion. Securities represent 11% of the average private investor portfolio (added to this must be fund certificates from investment companies, which also like to put some of their funds into annuities) – compared to the 24–26% which go into traditional investments in insurance companies and/or bank deposits. The lifting of restrictions and taxes on these forms of investment and the advances in information technology meant that in Germany too during the 1990s, funding and investing through the financial markets gained strongly in significance.

And yet much still has to be done before Germany has caught up with the level of development of the capital market in the United States, where for decades a large proportion of old-age pensions has had to be privately arranged and where 'certified documents' which provide liquidity and good returns, such as shares and bonds, are in great demand. Although certified documents have increased in Germany, the financial system remains more focused on banks than on capital markets.

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Stephan Paul

## Catholic social doctrines

### *The economic system in the social encyclicals*

The contemporary Catholic social doctrine dates back to the time when the Church was wrestling with the social question and when →liberalism and →socialism were the two economic theories competing for its solution. While liberalism predicted that free global markets would result in the 'wealth of nations' (Adam Smith), socialism (Karl Marx, Friedrich Engels) believed in the necessity of a 'class struggle' which would lead, through a historical process and via the 'dictatorship of the proletariat', to a 'classless society' (communism).

In the first social encyclical (world circulars) *Rerum Novarum* (1891), Pope Leo XIII levels harsh criticism at the early capitalist class society of the time (RN, nos 1/2). And yet, the liberal theory is not rejected outright, unlike the programme of the socialists. It is said to be a long way away from being able 'to contribute' something to the solution and is actually doing damage to 'the working classes themselves' (RN, no 3).

Instead of liberalism, Leo XIII demands 'fair wages' and a modification of the pure market principle, and pro-

claims the freedom of coalition (freedom of association) of the worker as a 'natural right'. He demands a national →social policy in favour of the workers. He thus saw the possibility of combining the related concepts of liberty as a fundamental value and the institution of the market with the idea of →social justice in such a way that they were in a state of equilibrium, which would be able to 'carry' the economic system and thus to 'tolerate' the tension between liberty and social equality.

This is the exact starting point of the social market economy which was subsequently set down by Walter →Eucken and Alfred →Müller-Armack. It is also the very topic of the second papal social encyclical *Quadragesimo Anno* (1931) 40 years later. Despite all the criticism of specifics, the 'capitalist way of running the economy cannot be condemned as such'. The point is, rather, 'to organise it properly' (QA, no 101), because 'unhampered competitive freedom' can easily lead to 'the survival of the fittest, who all too often tend to be more brutal and lacking in conscience' (QA, no 107).

Competitive freedom alone must never be made the 'principle which regulates the economy'. On the other hand, it is 'justified and of undoubted usefulness within the necessary limitations', provided it is 'firmly controlled and wisely governed' by the public welfare authority (QA, no 88). The pope also criticised the unfair distribution of wealth at the time (QA, no 60) and recommended the transformation of the wage-for-labour relationship into a 'business relationship', so that workers and employees can achieve 'co-ownership or co-management or some sort of profit-sharing' (QA, no 65).

The encyclical *Centesimus Annus* (1991) by Pope John Paul II forms the closing chapter of the statements of the Catholic social doctrine on the idea of a social market economy. Although the pope did not avail himself of this peculiarly German term, he still described the issue down to the finest details of the ethical principles of a social market economy. While the terms 'liberty' and 'social justice' defined the basic ethical values, the terms '→market mechanisms' and 'public control' described the two fundamental organising elements. 'Good employment opportunities' and a 'solid system of professional and social security' stressed the special protection of human labour and of those who are socially weak. The elements 'stable currency', 'healthy economic growth' and 'security of social relationships' were also mentioned. At the same time, a →market economy which lacks a legal framework, which is untamed and devoid of values, was rejected (see CA, no 19, 40-42).

### **Principles of social ethics**

According to the most important sentence in the Catholic social doctrine, the 'origin, carrier and goal' of all social processes always has to be the person. To that extent, he or she also has the right and the duty to look after his or her economic affairs with liberty, responsibility and solidarity.

A successful economy – understood as the best possible supply of goods for all in an atmosphere of liberty and social justice – first of all requires the institution of the market. The fundamental rights of freedom of production and consumer liberty, the free choice of occupation and of a workplace, and the

autonomous handling of →*property* in all its forms can be satisfactorily realised only by a free market order. This makes the market, as the institution of economic self-determination, the system's political consequence of the basic value of liberty. For a Christian anthropology to defend a free market system, is the necessary consequence of its view of human beings as free, responsible subjects.

A successful economy, however, cannot be achieved through the institution of the market alone. Since not nearly every human being 'can prosper in the market', the public welfare authority and its 'social balancing' institutions have to ensure that all society members are at least provided with those material goods which enable them to lead their lives with dignity. This criterion sets the social market economy apart from the individualism of the pure barter economy of the era of palaeo-liberalism (→*liberalism*).

### **Old and new goals**

The original theory of the social market economy knows three ethical goals. The first and most important of these is an optimal goods supply, which can be achieved only when the economic agents enjoy the freedom that forms the basis of their economic creativity. The second economic goal is the guarantee of decent conditions in the workplace. While classical liberalism sees even the labour market as exclusively subject to the law of supply and demand, Leo XIII (*Rerum Novarum*) already envisaged a framework of public legislation for a 'reasonable minimum level of protection of human labour'. Today, the individual and collective industrial law, and also a specific independent labour juris-

diction, serve this purpose. The third goal is the solidarity with the 'economically weak and the economically passive', as it was systematically developed through the 'system of social security'. Today, the ecological compatibility and the 'global economical reasonableness' of a fourth goal – 'renewed social market economy economic processes' – have to be taken into account as a new ethical goal of a social market economy.

The goals of a social market economy cannot be reached through →*competition* alone, but only through a basic legal framework which is instituted by the state and within which the market process plays itself out.

The Christian image of humans stresses both the liberty and the autonomy of the person as well as the fact that all people have equal dignity. The concept of 'social justice' as equality born out of solidarity, is possible only to the extent to which liberty, autonomy and self-interest – which is ever present – can unfold. Only in that way can an economy generate the sort of productivity that makes prosperity and social equality possible. Over time, the social market economy and the social security state associated with it have brought about an enormous redistribution – one that is responsible for the allocation of one-third of the national product. There is, however, the danger that the inherent link between personal achievement and the social efficiency of the social market economy may fall into oblivion. Gradually, an 'insurance-against-all-risks mentality' that considers the 'comprehensive supply' to be normal at all times has started to take hold.

The combination of increasing economic →*globalisation* with a continually

ageing society means that the relationship between expenditure and returns must be 're-set'. The service base of our welfare state that is based on the subsidiarity principle has become too narrow to be able to continue holding up the social superstructure in the same way. We therefore need to change our course in the direction of more personal self-help, socially organised solidarity and economic autonomy.

Under today's conditions the questions that have to be repeated include: Which solidarity services are indispensable for dignity's sake and for the sake of the social rights associated with it? And which previous social security benefits should partly be replaced by reasonable personal contributions?

If anyone wants to prevent this debate (→*types of market economy*) in the name of a misunderstood 'social justice', the result will be that everybody loses out. A transformed social market economy therefore includes, above all, an emphasis on the subsidiarity principle according to which each individual not only has the right but also the duty to do all that he or she is capable of doing. This applies to integration in the job market, the acquisition of knowledge and education, and the ability to accumulate assets and to make financial arrangements for their retirement and times of need.

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Lothar Roos

## Chamber system

Chambers are generally based on the principle of autonomy. Autonomy means that the members of a self-governing corporation accept sole responsibility for their affairs and deal with them independently. First initiated by the Stein-Hardenberg reforms at the beginning of the 19th century, autonomy is an important organising principle of democratic states.

Autonomy carries special significance for regional government authorities (municipalities and municipal associations) whose right to self-government is constitutionally guaranteed in Article 28 of the Basic Law. In this way, the citizens are encouraged to become more involved in public administration.

Apart from municipal autonomy, there is economic autonomy, autonomy of the professions and social autonomy. Bodies responsible for economic autonomy are the → *chambers of commerce and industry*; for the professions, for example, the physicians' chambers, legal chambers and architects' associations; for social autonomy, the social security system. The following organisational principles apply to all chambers:

- They are bodies of the public law, i.e. they have been legally instituted by the state and they have been entrusted with the responsibility for certain tasks.
- The law specifies who belongs to the chambers as (compulsory) members (e.g. all business people, all trades people, all physicians, etc.).
- Through their own contributions, the members of the chambers raise the funds required to fulfil their objectives and they supervise the appropriate and economical use of these funds.

All self-governing corporations typically have representatives who have been elected by the members and who have been accorded significant rights to participate in the appointments for the highest and honorary offices, as well as with the determination of the budget and decision on fundamental issues.

The state establishes the chambers in order to benefit from their expert knowledge so that appropriate local and national tasks are undertaken, and in order to reduce the load on its own administrative mechanisms. The chambers are also an extension of the subsidiarity principle, in terms of which smaller units (e.g. the family or a municipality) should settle their affairs themselves and call on the support of larger units (e.g. a state or a federation) only if the involvement of higher authorities is required for the successful undertaking of a particular activity.

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## **Chambers of commerce and industry**

German chambers of commerce and industry are corporations established in terms of the public law and are thus the official representatives of the commercial sector of the economy in its dealings with the state. Regional chambers of commerce and industry look after →enterprises of all sizes.

A total of 3.5 million enterprises are grouped together in members' association of the chambers of commerce and industry in Germany. The membership of all commercial enterprises in the chambers of commerce and industry guarantees that each enterprise can exercise equal influence. There is no weighting of votes with majority decisions according to size; each enterprise has an equal right to vote. This representation of enterprises has the effect of balancing the interests of enterprises and industries.

The members of the chamber (enterprises) elect their representatives to the chamber's plenary assembly, which elects the president, the vice-president and the managing director of the chamber. This means that the president of a chamber also has to be an entrepreneur. Since most representatives come from enterprises which belong to the middle class, the chambers of commerce and industry are particularly focused on the needs of this group. The fact that membership of regional chambers of commerce and industry is compulsory, allows them to remain independent of government subsidies and secures their objectivity and reliability when they have to give political advice.



The task of the chambers is to promote regional commerce and industry. The preparation of reports – on some 200 different areas of expertise – for courts, authorities and private petitioners is of particular importance, since they are prerequisites for trading and professional licences.

The chambers are particularly keen on the promotion of the education system and on the improvement and effectiveness of in-house training and further education systems. Their advisory role towards companies that take in trainees, their apprentice-mentoring scheme, and the involvement of more than 120,000 honorary examiners in examinations, commit the chambers to lending the skills-training sector their continued structural support.

It is hoped that in this way a qualified workforce will bring competitive advantages and that long-term market positions will be able to be established and evolved. In the area of →*environmental protection*, statements by the chambers of commerce and industry generally serve the purpose of modifying environmental policy measures in the interests of industry and commerce.

Altogether the chambers offer their member enterprises a broad range of information and services aimed at making their businesses structurally more efficient and improving their market position. A total of 6,600 experts are responsible for the area-specific support of the enterprises in the chambers. Innovative economic trends as well as practical business activities are brought to the enterprises' attention in regularly edited chamber publications – there are, for example, a total of 79 different magazines totalling 2.5 million copies.

Another important characteristic is the cooperation between full-time staff and the 250,000 odd voluntary staff members who have business backgrounds and who are active in chamber organisations and committees.

Selected examples of what the chambers of commerce and industry information service can achieve are the Business Start-up Forum, the company information system (for the exchange of suppliers' and manufacturers' details), the e-trade centre as well as the Technology and Recycling Forum.

The umbrella organisation of the German chambers of commerce and industry is the Association of German Chambers of Industry and Commerce, which employs more than 160 staff members at its headquarters in Berlin. The association represents the interests of the individual chambers in its dealings with the federal government, issues press releases and statements on topical issues in the realm of politics and the economy, and assists interested parties with the establishment of international contacts. The chambers set the guidelines for the association and finance its activities.

The growing importance of the organs of the →*European Union* in the field of economic and social policy has necessitated the establishment of a transnational lobby which can deal with European policy issues on behalf of commerce and industry. This role has been adopted by Eurochambres in Brussels in its capacity as the umbrella organisation of more than 800 European chambers, which in turn look after 10 million enterprises.

The Association of German Chambers of Industry and Commerce

coordinates the 120 bilateral foreign trade chambers of commerce in 80 countries. These bilateral chambers are the first dialogue partners for German or foreign business people.

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### **Circular flow of incomes, national income and national product**

The idea that money changes hands, circulates and, perhaps, forms a cycle is based on everyday experience. Inspired by scientific discoveries on the circulation of blood and water, 18th century economists were the first to see the possibility of representing economic processes as a cycle.

The first cycle theoretician was François Quesnay (1694–1774) who, besides his duties as personal physician to the Marquise de Pompadour at the Court of Louis XV at Versailles, dedicated himself to studies on philosophy and economics. Quesnay tried to show how the landowners' annual capital advances can be recovered through agriculture and trade, so that they become available again in the following year.

In the next century, Karl Marx (1818–1883) and after him Eugen von Böhm-Bawerk (1851–1914) were

working on a model of the national economy in cycle form. Typical of this form of representation is a network of circulatory nodes, which take on the role of functional and institutional transactors.

The functional transactors are usually markets (changing capital assets), and the institutions are sectors of the economy (the government, private households, enterprises and possibly other countries). The interactions between the circulatory nodes are represented by currents, with each goods' current being paired with an equivalent monetary counter-current (e.g. consumer goods from enterprises to households, consumer expenditure from households to enterprises).

The operational pattern of the circular flow of incomes rests on the fundamental idea that income is obtained through expenditure (and not vice versa), and that the conditions for the repeatability of this circulatory process depend on this.

This is the main focus of cycle analysis, which investigates the equilibrium, structure and level of the economic currents and existing stock in the cycle, and also the resulting behaviour of the economic agents (*ex ante* cycle analysis). The circular flow of incomes serves as a theoretical model for the national accounting in an economy.

The interdependence of the components of the cycle means that this book-keeping system has three different ways of calculating the national product. The output method, the incomes received method, and the consumption-savings method taken together add up to an algebraic representation of the circular flow of incomes.

The 'consumption-savings method' indicates how the economic units spend their  $\rightarrow$ income and how manufactured goods are used in one period: private households and the state consume, private  $\rightarrow$ enterprises and the state invest. In an open national economy, the external balance (the surplus of exports over imports) also counts.

The 'output method' shows the relationship between production and income. The overall result is the sum of the gross values added (gross production value less the costs of what had to be used in the production process) of the individual businesses and the state.

The 'incomes received method' initially determines the national income and shows how the factors of production used in the manufacturing process (labour, capital, land) participate in the final income. It must be roughly subdivided into the gross wages and salaries for employees and into profits for the self-employed and factor capital (income from entrepreneurial activity and capital assets). The income distributed by the market in this way is usually subject to a secondary distribution through the national tax transfer system and is then available for use – this is how the circular flow of incomes closes.

Sophisticated methods of calculation produce different varieties of national product. Besides gross national income (GNI) (which used to be referred to as gross national product – GNP), gross domestic product (GDP) plays an important role for economic stability ( $\rightarrow$ business cycles,  $\rightarrow$ business cycle policy). The difference between the two variables is due to the application of the home and/or the domestic concept which, via the balance of the factor

incomes from other countries (income earned at home which is transferred abroad, minus the income that was obtained abroad and was transferred back home) and via the  $\rightarrow$ subsidies and production and import duties within the European Union, become mutually exchangeable. The difference between gross and net entities determines the level of depreciation. Finally, government interventions in the form of direct taxes and subsidies distort the original factor costs and thus the actual market prices so that, strictly speaking, the appropriate evaluation basis should be indicated for each aggregate.

The widely used concept of national income can now be translated into the terminology of macroeconomic interdependence: the issue is net national income at factor cost.

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### Co-determination

Co-determination is the participation of the workers in the decisions of their  $\rightarrow$ enterprise. Depending on the form and size of the enterprise, the participation

rights of the workers differ. In the mining as well as the iron and steel industries (Montan Co-determination), workers have the most extensive rights to co-determination: here, the supervisory boards have equal numbers of employers' and workers' representatives (parity); in addition, the appointment of the labour relations manager requires the approval of the majority of the workers' representatives on the supervisory board.

Other large-scale incorporated enterprises (corporations such as public limited companies, limited partnerships by shares, limited liability companies, mutual insurance companies and cooperatives) with a minimum of 2,000 employees also have to have an equal number of workers' and employers' representatives on their supervisory boards with the proviso that, in the case of a deadlock, the employers' side has the final say. In addition, employees in managerial positions have representation in the workers' quota. In medium-sized enterprises with between 500 and 2,000 employees, the workers are entitled to a one-third representation on the supervisory boards.

Non-incorporated firms (private firms, general partnerships, limited partnerships) are not subject to co-determination regulations. The same applies to government enterprises, where special legal regulations for the representation of employees in the administrative councils are applied.

Co-determination refers to all decisions that have to be taken by an enterprise's supervisory board. This has to be distinguished from the participation of the works council in terms of the industrial relations law, which exists alongside co-determination.

The extent to which the workers can exercise co-determination depends on the legal form of the enterprise. It is most visible in the case of public limited companies where the supervisory board is in control of the board of directors: the appointment of the executive committee is incumbent upon the supervisory board and not the general shareholders' assembly. This ensures that the supervisory board can influence the board of directors on an ongoing basis, which for its part is exclusively accountable to the supervisory board.

In the case of a limited liability company, provided that it is large enough to require co-determination, the executive directors are equally appointed by the supervisory board, which is itself accountable to the partners – and thus the shareholders. This means that in limited liability companies, the committees with co-determination rights have only limited influence.

In comparison with other countries, German co-determination law is very comprehensive. Historically, co-determination – above all in the mining, iron and steel industries – represented an alternative to the nationalisation which is discussed elsewhere and which was hotly debated after the Second World War. Capital and labour were to be institutionally integrated and forced to cooperate. And it is true that in Germany a culture of partnership between employers and employees developed.

For many years now, conflicts of interest have been almost exclusively dealt with in a climate of social harmony: industrial action is less frequent, shorter and usually less irreconcilable than it is in comparable industrial nations. As a result, workers are in a

position to partake in the increasing prosperity. It is thanks to the concept of the →*social market economy* that the economic system was accepted virtually from the start. In the meantime, however, the traditional division between capital and labour is becoming increasingly blurred: an ever-increasing number of workers have become shareholders either in their or in other enterprises.

In view of the increasing internationalisation of the economy (→*globalisation*), the criticism has repeatedly been raised that the German co-determination law is beginning to turn into a locational disadvantage; it complicates decision-making processes and decreases profitability. However, co-determination enables the workers to identify better with company objectives. Thus, the criticism is usually less targeted at the underlying idea than at certain forms of co-determination.

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## Collective agreements

Article 9(3) of the German Basic Law guarantees bargaining autonomy: workers and employers have the right to club together in trade unions and employers' associations, and to organise their work-

ing and remuneration conditions independently of government directives and in their own responsibility. This is done mainly through collective agreements that can refer either to a single →*enterprise* or to an entire industry.

The area of application of these agreements can be limited to a specific region or cover the Federal Republic as a whole. Collective agreements may specify the actual rights and obligations of workers and employers – such as regarding wage levels or working hours – but they may also contain legally binding standards, which for those concerned are directly valid and as such similar to a law. They concern all employers in the area of application with membership in the respective employers' association, and all employees who belong to the participating trade union. But it is normal practice to allow non-aligned workers to share in the outcome of collective agreements.

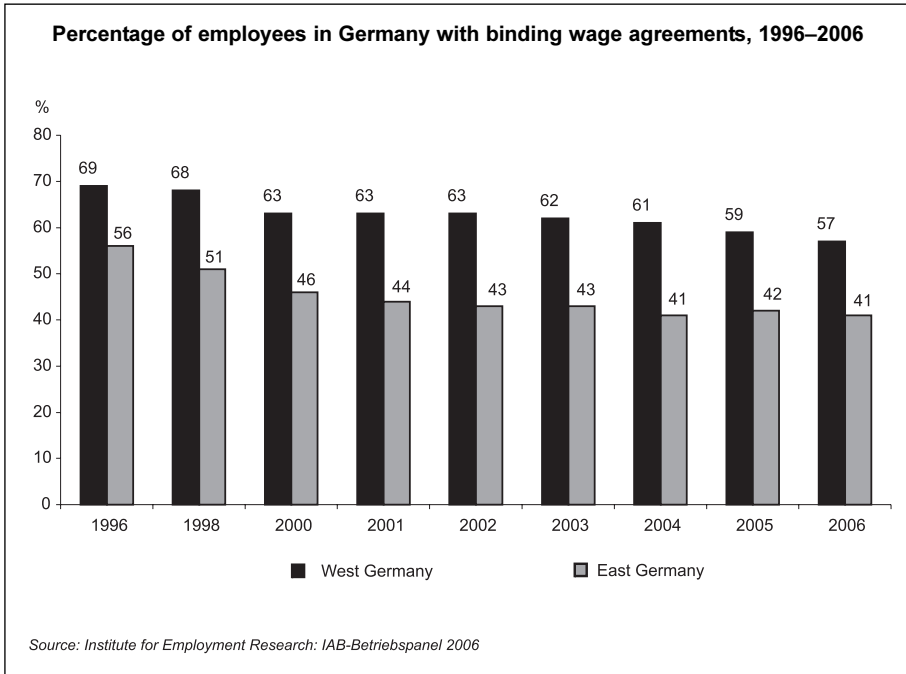
Collective agreements regulate working conditions collectively and are regularly brought in line with new economic developments. This means that the individual clauses of employment contracts do not have to be renegotiated every time. Thus collective agreements play an important logistical role. They also have a protective function for the individual worker facing an employer, who is usually in an economically stronger position. But collective agreements also protect the individual employers who, when faced with the organisational power of a large trade union, would achieve little on their own. Lastly, collective agreements play a peace-making role when, over long periods of time, they keep the workplace free from exhausting conflicts.

While industry-wide agreements on conditions of employment usually remain valid for longer periods, wage and remuneration agreements have to be amended more frequently, with terms that make it easier to monitor developments. But there are many more collective agreements on additional benefits such as entitlement to vacation, payments for the purpose of wealth accumulation or irregular payments. These collective agreements apply simultaneously and usually for different lengths of time. At present, more than 50,000 collective agreements are in force.

Collective agreements cannot overrule any laws or regulations. A deviation from the national minimum standards is in theory permissible provided, however, it is in favour of the workers. Works councils are empowered to finalise company agreements but not

collective agreements. Such company agreements may deviate from collectively agreed regulations only when they are in favour of the workers – unless an ‘opening clause’ in the collective agreement specifically grants the right to exceptions.

Attempts to influence collective agreements through industrial action are permissible. The right to →*industrial action* is guaranteed in Article 9 of the Basic Law. Its details have nevertheless not been legally regulated, but are based on precedents. A strike is an example of industrial action and is defined as the joint refusal to work with the intention of achieving a collective agreement by force. A lockout is the employers’ answer to a strike; it means that workers are not allowed access to the workplace and are refused wages. Both the trade unions and employers’ associations lay down procedural rules that



apply in the event of industrial action, such as a call for a strike ballot on the workers' side, or an appropriate joint resolution on the side of the employers.

Any kind of industrial action is required to adhere to the rule of proportionality at all times. Equally, nobody can be made to participate in a labour dispute by force. Industrial action can relate to any aspect of tariff negotiations, but selective strikes restricted to individual companies are also allowed. While industrial action is taking place, the workers and companies involved usually receive financial support from their associations.

In principle, industrial action may be taken only when the truce has expired after an existing collective agreement has come to the end of its life. Short token strikes in close association with collective bargaining are, however, considered admissible. But industrial action is illegal if it is a political strike whose target is the legislator. Meanwhile, the initial controversy over the validity of lockouts has been resolved by a judgment of the Federal Constitutional Court and the Federal Labour Court.

A collective agreement can sometimes be extended to workers and employers who are non-aligned, provided that the collective agreement was declared universally binding. This applies at present to fewer than 600 collective agreements. In order to be declared universally binding, an application from at least one of the parties to the collective agreement and a vote in favour by a wage committee where both parties are equally represented are required. It is furthermore permissible only if there is interest from the public

and if more than half of the workers in the area of application of the collective agreement are working for employers who are aligned.

Minimum wages, which have not been legally specified in Germany, can be achieved only via the detour of universally binding collective agreements. But to declare collective agreements universally binding is legally and politically controversial because they also place an obligation on employers who openly state that they do not wish to be aligned with tariff negotiations. A judgment of the Federal Constitutional Court has, however, declared them permissible. Collective agreements regulate minimum requirements. They do not prevent anyone from granting workers benefits that are above the collectively agreed wage limits. Benefits that are above the collectively agreed wage limits can be granted either through company agreements or through a single contract.

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Gernot Fritz

## Competition

Competition means people fighting over something. Economic competition exists in the rivalry for business deals. In order to be successful in the market,

suppliers and bidders have to offer their business partners favourable trading conditions. These depend equally on attractive prices (price competition), high product quality (quality competition), the right approach to sales and marketing, and possibly also on successful advertising.

In a  $\rightarrow$ market economy, competition fulfils a number of important tasks. These are listed as the different functions of competition (*see box below*). First and foremost, the power of the state versus the private citizen needs to be restricted. Different from a planned economy ( $\rightarrow$ socialism), the economic process is not mainly controlled by the state but directly by the private actors in the economy (the controls inherent in the market economy on the basis of liberal economic rights). Secondly, competition controls the economic power of private actors. Only those whose business conditions are permanently attractive have the chance to be successful (competitive self-check). These two functions of competition are socio-politically important and are therefore referred to as ‘classical political functions’.

But competition also has economic functions. First, competition requires that a finished product has to suit the needs of the customer as closely as possible (focus on consumer demands). Second, in order to maximise profits the scarce factors of production – labour, land and capital – are used in such a way that their productivity is highest (decreasing factor costs). The third point is that the income distribution taking place is a function of one’s performance in the market process – i.e. what sort of contribution is made to overcoming the scarcity of goods (income in accordance with market performance). Fourth, competition sends out incentives for the introduction of new or improved products and production methods (incentive to be innovative). Fifth, competition accelerates the speed at which competitors react to such innovations or other changes in the economic environment (e.g. changes to international trade relations) and thus contributes to making the innovation known to the entire economy (imitation of innovations and general high flexibility of the economy).

The first three functions are called

#### Competition and its functions in a market economy

##### **Classical political functions of competition**

- Limiting the impact of state power on the private citizen
- Control of private economic power

##### **Static functions of competition**

- Composition of the goods supply according to consumer needs
- Optimal utilisation of factors of production
- Income distribution according to market performance

##### **Dynamic functions of competition**

- Innovative products and production methods
- Imitations and a high degree of adaptability



'static competition functions', because they work particularly well when the economic indicators are static. In contrast, the fourth and fifth functions are referred to as 'dynamic competition functions' because they take into account overall economic changes over time, consumer needs, the available factors of production, the technical and organisational knowledge of how to combine the factors of production ( $\rightarrow$ *production and supply*), as well as the legal and the  $\rightarrow$ *social system* within which the competition takes place. Beyond that, innovative suppliers in their constant search for profit opportunities are also a source of change. Through competition, they have to test whether their new ideas are actually suited to need satisfaction. The truth is that only the most successful new developments are rewarded with high  $\rightarrow$ *profits* (competition as a process of search and discovery).

The more successful an adventurous pioneer-entrepreneur is, the more pressure others will feel to catch up with his or her competitive advantage or even to overtake him or her. This may be based on the hope of being able to participate in the innovator's successes. There is, however, always the fear of not doing enough and of having to quit the market.

At the same time it is plausible that market participants will try to ease the constant competitive pressure by means of restrictive cooperation with other  $\rightarrow$ *enterprises*, or by seizing individual control of the market. Without a protective governmental policy, therefore, the competition process could be rapidly suffocated. It also has to be considered that competitive conditions differ

in different markets. The situation is completely unproblematical if new suppliers (potential competitors) can enter a market at any time, i.e. if the market has low entry barriers and is 'open'. Here, the current suppliers cannot successfully restrict competition and, for example, raise prices, because they would otherwise be quickly disempowered by new market entrants (newcomers). In this case, a special competition policy is not necessary ( $\rightarrow$ *open markets: market entry, market exit*).

In reality, however, potential suppliers to the market are often hampered by economic barriers – and sometimes also by legal barriers – which are difficult to overcome. It is then important to maintain the rivalry between the current suppliers: the competition policy must prevent these suppliers from entering into restrictive contracts, for example, in the form of monopolies or mergers. Even if there are a great many enterprises in the market (polypoly), competition could be eliminated to the detriment of the consumer.

But competition is even more at risk if there are only a few enterprises in the market (wide oligopoly). They may dispense with contracts altogether and agree trading conditions jointly and severally, through informal telephone calls or conferences which are open only to the industry. If the number of suppliers becomes smaller still, all other things being equal, the enterprises may even exhibit solidarity without any previous contact whatsoever (close oligopoly). In that case, if one supplier increases prices, the others follow suit 'spontaneously'. The enterprises behave like a quasi-monopoly. Exceptional cases may force the government

to intervene by changing the market structure and increasing the number of suppliers. This may be done, for example, by making it easier for newcomers to gain access to the market or, in extreme cases, by breaking up the established enterprises in order to resuscitate competition.

Even if, due to its functions, competition makes an important contribution to social prosperity, it nevertheless cannot fulfil all the requirements of a market economy (the limitations of competition). This is why the government complements competition with its economic policy. Apart from the policy against restraints of competition ( $\rightarrow$ *Act Against Restraints of Competition*), it is of primary importance that regulations for those sectors of the economy are put in place where competition has no chance of success. This applies especially to the supply of public goods by the state (e.g. internal and external security). In addition, the state can correct – through, for example, environmental policies – detrimental developments due to competition, making sure that third parties do not suffer negative external consequences.

Next, it has to be taken into account that the income distribution which results from the market process reflects the market performance of the individual participants in the economy, without necessarily paying attention to their neediness. For this reason, the state undertakes to correct the income distribution – for example, in favour of ill or disabled persons as well as families with children ( $\rightarrow$ *social policy*). However, the greater the deviation from a  $\rightarrow$ *distribution* in accordance with market performance, the greater is the danger that

the readiness of the market participants to perform will decline, undermining the control function of competition.

Finally, the state tries to flatten extreme economic fluctuations which do occur when competition is given free rein. The specific targets here are full  $\rightarrow$ *employment*,  $\rightarrow$ *price level stability*,  $\rightarrow$ *balance of payments equilibrium* and economic growth.

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Hans Peter Seitel

## Concentration

The  $\rightarrow$ *social market economy*, which is the accepted way of life in Germany and enjoys majority support, can only function if economic and political powers are not excessively concentrated and thus out of control. Only in this way can socially relevant political and economic decisions be made and implemented in an essentially decentralised manner.

The most important aspect of the problem in terms of market and competition criteria is enterprise concentration, which depends on the number of  $\rightarrow$ *enterprises* operating in a market. From the point of view of competition

– or considered more generally in terms of the goals of a social market economy – enterprise concentration can be seen either in a positive or a negative light. It must be seen as positive if it is thanks to the concentration that an enterprise manages to remain competitive and profitable and offers secure jobs. A negative evaluation is appropriate if there is actually only one enterprise on the seller's or the buyer's side. In such monopoly situations →*competition* cannot work and achieve the desired results. For this reason, modern antitrust legislation envisages rules designed to prevent an excessive enterprise concentration, which would have a negative impact on competition.

Just like the rest of modern antitrust legislation, German law is not designed to hamper the internal growth of enterprises. This sort of concentration and market presence is usually based on the superior performance and capability of the enterprise, and is not a punishable offence. If this has allowed an excessive enterprise concentration to develop, then only the law against abuse of market position applies. The state replaces the control function of competition with government controls, which can naturally only be a temporary measure (supervision of abuse).

It is better to prevent an excessive enterprise concentration from the start, unless it is due to internal growth and superior efficiency. The 'merger control' in modern restrictive trade practice acts, serves this purpose. That also applies to the German and the European law valid in Germany. The →*Act Against Restraints of Competition* requires that for control purposes, mergers of companies which fulfil cer-

tain criteria have to be registered with the →*Federal Cartel Office* prior to their execution.

The main criterion is that the enterprises involved must have had total sales revenues of more than €500 million during the past financial year worldwide, and at least one associated enterprise in the same country must have made sales revenues in excess of €25 million.

In terms of the Act Against Restraints of Competition, such mergers are generally not permissible if they either justify or strengthen a dominant market position, thus leading to an excessive concentration. The Act against Restraints of Competition defines an enterprise as 'dominating the market' when there is no competitor in the relevant market, when the enterprise is not being exposed to any significant competition, or when it has an 'outstanding market position' relative to its competitors.

For the regular review of the level of enterprise concentration and the implementation of merger control, an independent monopolies commission has been established, consisting of five expert members. Every two years, the commission submits a major report and it also compiles special reports on individual cases and problems.

Enterprise concentration in a social market economy – and this equally applies to wealth concentration – is not merely of 'economic' importance in the narrower sense of the word. Both forms of economic concentration can also give access to political influence. This can be seen at the level of the municipality, for instance, where a large enterprise opens up. To prevent the sort of concentration of political power typical of totalitarian

and other undemocratic forms of government, the German constitution not only insists on the classical division of power between the legislature, the executive and the judiciary, but beyond that there is also the decentralisation of power at the federal level, the states, the municipalities and, on the other hand, Europe, which has attracted significant areas of control by now (→*Federal Republic, federal states, municipalities*).

In a social market economy, the sort of procedures for the decentralisation of political power which are also effective in other federal democracies are usefully supported by the prevention of an excessive concentration of power in the economic sense, which might be converted into the sort of political influence which is not legitimate in a democracy.

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*Kurt Stockmann*

**Concerted Action and Alliance for Employment (*Konzertierte Aktion/ Bündnis für Arbeit*)**

The red-green (Social Democratic Party-Green Party) federal government officially declared alliances with interest groups a core component of their consensual economic policy. A 'Concerted Action', organised by the state, with representatives from government, the trade unions and the employers' associations already existed from 1967 to 1977. In 1977, the Concerted Action in the Health Service, which still exists

today, was legally established. What is the purpose of the establishment of such institutions, what are their chances of success, and what kind of unfavourable consequences are to be expected?

Concerted actions and alliances are information and negotiation systems through which government representatives and the representatives of organised interest groups endeavour to answer contentious questions regarding which way would be beneficial for the economy as a whole.

The Concerted Action which was created in 1967 was supposed to determine reference levels for economically justifiable wage increases and in this way keep inflation and →*unemployment* down. The resolutions were only equivalent to recommendations and thus not binding for the participant representatives of the employers' associations and trade unions.

The purpose of the Concerted Action in the Health Service is to slow down the steep rise in expenditure of the compulsory →*health insurance* and thus to prevent contribution increases (rising wage additive costs). Members from all sectors of the health service are expected to commit themselves to the economical use of funds.

The Alliance for Employment, Education and Competitive Ability, which was started in 1998, is particularly focused on effective measures against high unemployment through agreements between trade unions, employers and the federal government. Political decisions were to be taken in agreement with the trade unions and employers' associations (corporatism).

In fact, the success of institutions of this kind was short-lived. An important

role in this is played by moderate wage demands of the trade unions. After 1967, these were necessary due to weakening economic stability ( $\rightarrow$  *business cycle policy*) and, in 2000, they were caused by the high levels of long-term unemployment, particularly among poorly skilled workers (minimum wage unemployment) for which wage policies were partly to blame.

In the Concerted Action in the Health Service, after expenditure had gone up excessively, cost-curbing appeals initially bore fruit. But thereafter, the expenditure dynamics returned in full force.

The reasons why concerted actions and alliances of all kinds fail are obvious. At first, all those involved are keen to show their goodwill and to work for the common goals. Initially it is even possible to garner the sympathy of the members of the represented bodies and to persuade them to relinquish their claims. Threats of legal enforcement action (as in the case of the Concerted Action in the Health Service) from government bodies can also have a disciplining effect. All corporations are united at all times in their demands for more government funding. In order to be able to present alliances as success stories, governments often agree to such requests (e.g. the employment programme for unemployed adolescents).

However, the consensus between the participating associations usually starts to crumble early on: dissatisfaction grows; members rebel; association leaders and trade union bosses are concerned about their re-election; and those sitting around the alliance table have no way of enforcing the promises

that have been made in their organisations. If individual groups violate shared resolutions they may benefit as long as most of the other associations do not follow suit: in this way, one small trade union which decides to go it alone and to disregard tariff guidelines causes its members to be financially better off, because unfavourable consequences in the shape of rising inflation rates (falling real wages) do not occur. But once the dam of moderate wage demands has been broken, other trade unions will do the same. There are no sanctions for offences.

Concerted actions and alliances cause false incentives: those who violate resolutions benefit; those who stick to them are worse off. The durability of alliances is therefore questionable.

Also, constitutional doubts exist against the Alliance for Employment, although it is praised as an instrument of consensual economic policy. The federal government ought not to share the political power with which it has temporarily been entrusted, with interest groups which have no democratic legitimacy. Furthermore, it is questionable that only a few privileged individuals are invited to consensus discussions when large sectors of the population, including some 25 million pensioners and unemployed, are excluded. There is a danger that those sitting around the negotiating table come to an agreement which is to the detriment of the groups of the population that are not represented.

A further shortcoming is the fact that all alliance participants are concerned about their re-election, which means that they only consider the immediate future. Successes need to be

achieved quickly, while lasting, long-term advantages are not considered. Also, the sorts of resolutions that the quest for consensus will yield cannot be foreseen. The result is a high degree of discouraging uncertainty for investors. This is not the way to steer a clear and reliable political course. Finally, parliament becomes disempowered as it is now expected to take decisions that have been pre-determined by alliances.

The Concerted Action in the Health Service did not fulfil its expectations. It was not possible to balance the conflicting interests of those involved through negotiations. More and more government spending cuts have been the result.

The Alliance for Employment died a quiet death despite the continued rise in unemployment. Something which had been commended as a milestone of red-green policy has now proved to be a failure. This makes it even more important to combat the causes of mass unemployment with suitable measures, including a moderate wage policy, opening up blanket collective agreements (allowing individual agreements on wages and working hours), social reforms and the removal of the numerous legal regulations and superfluous job market layering.

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Walter Hamm

### Conflicting aims in economic policy

Economic policy aims can interrelate in different ways. It follows that two aims which are pursued at the same time can be mutually inclusive and in tune with each other. In that case, the aims are in harmony. In the pursuit of the one, the other aim is promoted at the same time. But, in economic policy, different aims are frequently in conflict. In such a case, the one aim can be achieved only if the other one is either sacrificed or achieved only to a limited extent.

Conflicting aims can almost be seen as the essence of any economic process. Since we have only a limited amount of goods, every individual continually has to decide which goods he/she can do without in order to be able to enjoy the benefits of other goods. People who are economically active will try to take these decisions rationally, and in this way will solve conflicting aims on a continual basis. In a  $\rightarrow$ market economy, it is largely up to individuals, households and  $\rightarrow$ enterprises to make economic decisions themselves in order to solve these conflicting aims. This is the best way of taking account of personal desires and preferences.

In a market economy, however, some decisions which concern the community have to be made on behalf of society as a whole. Whether, for instance, a motorway or an airport should be built, or whether the money

supply should be increased and by how much, must be decided by the various responsible administrative bodies. However, because in that case the decisions are not primarily personal ones but concern the community, the number of potentially conflicting aims is greater.

There are essentially three reasons for this. The first is that there are a great variety of different individuals and groups of people, all of whom have very different tastes and expectations in terms of economic policy. Thus people who enjoy travelling or who have to travel for business reasons want to have an airport close by which is well appointed and has all the amenities. Those, however, who live in direct proximity of the airport without doing so much travelling are likely to be opposed to such a development. By weighing up the interests of different groups of people against each other, economic policy-makers solve conflicting aims.

A second reason why economic policy decisions are so beset by conflicting aims is that politicians also have their own interests. All too often their personal interests will not be in harmony with the interests of their constituencies. Since it is the former who are taking the decisions in the end, they are clearly in a more powerful position, which means that they can, if they are so inclined, take decisions which are useful to them but detrimental to society as a whole. For a long time, economic policy-makers were simply told that their decisions must be based on the common good and not on their own interests. But even those who were not completely cynical about human

nature finally understood that this attitude was not very helpful. Nowadays, we concede that all suppliers and consumers in the different markets are basically following their own interests, because we have learnt that the markets coordinate these different interests quite successfully.

Should an economic policy-maker be allowed to act in his/her own interest if he/she is honest about it? If the answer is yes, institutions are necessary which have a similar effect as the markets on coordinating the interests of the economic policy-makers with those of the electorate. And there are such institutions, the most important being the democratic system, the constitutional state and the freedom of the media. These taken together ensure that politicians who continue to solve conflicting aims to their own benefit and against the interests of the population, will not remain in office for long. This forces them to include the interests of the electorate in the pursuit of their own goals.

A third source of conflicting aims in economic policy is somewhat more difficult to understand and arises from the fact that economic decisions are generally based on expectations of human behaviour. The following is a classical example: since inflation is generally regarded as undesirable, one might expect that governments will always do their best to keep the inflation rate low. But that is not necessarily the case.

The reason for this has to do with the fact that there is often a time delay before the electorate wake up to the fact that inflation is going up. When this happens, workers might forego higher wage demands in order to make up for the losses they are incurring as a result

of inflationary prices. For business, this means that their profits are going up while their labour costs remain static due to the unchanged wages. Thus labour is becoming more profitable for business, which means that they can take on more workers. The result of inflation is therefore a decrease in unemployment!

Precisely this is the essence of what is possibly the most famous example of conflicting aims in economic policy – the one between the fight against inflation on the one hand and →*unemployment* on the other. For a long time it was widely thought that unemployment could be effectively lowered through a little more inflation.

In actual fact, this cannot work for long because the workers will obviously soon become aware of the higher inflation rate and will demand higher wages. Then, after only a brief recovery phase, unemployment will return to its previous level, while company →*profits* go down again. What remains is inflation. Sometimes a government is content if unemployment just goes down for a short time – perhaps until after the next election. Or a government is hoping just to be able to cope with a threatening recession. It is for reasons such as these that governments may not take the fight against inflation as seriously as they should for the sake of the electorate.

Today the central banks in many countries are independent of the government. This is supposed to ensure that their executives, who are mainly responsible for the fight against inflation, are not tempted to buy better employment figures with inflation, only to find that the improvement does not last.

In general, the conflicting aims at the economic policy level are more complex and more problematical than they are at the level of individual economic acting. This is only one of many reasons why an →*institutional order policy* which takes the desires of the citizens into account, leaves as many decisions as possible to the citizens themselves. The background for this is nothing less than the principle of subsidiarity, which plays a central role in the concept of the →*social market economy*.

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Thomas Apolte

## Conservatism

Colloquially, conservatism (or conservatism) is defined as the characteristically human attitude of preserving (traditionalism), which sometimes has the consequence of people stubbornly holding on to things which have become outdated (reactionary thinking).

There is no clear connection between this fact and the conservatism which is a specific branch of the intellectual and political history that links →*liberalism* and →*socialism*.

The intellectual development of conservatism starts with the critique of the *Enlightenment and Rationalism to the Social Conservatism* (G. Schmoller and



the Society for Social Policy, 1872), the 'conservative revolution' and the critique of the Frankfurt School right up to today's cultural and social criticism. The political line goes back to the debate on the French Revolution, moves on to the establishment of the first conservative parties (England, 1832) and Bismarck's social legislation (1883 and after), and leads on to national conservatism in the Weimar Republic and the Christian Democratic and Conservative parties of the German Federal Republic (Christian Democratic Union – CDU and Christian Social Union – CSU).

In each phase of its intellectual and political development, conservatism has emphasised equality and the need to look ahead. But equality was balanced by liberty, responsibility and authority, while rationalism was balanced by the organising forces of reason; evolution and tradition were set against revolution; values, ethics and morality against indifference and arbitrariness; nation and state against anarchy and chaos; confidence in the future and experience against →*constructivism* and →*interventionism*. Above all, conservatism of every shade is connected with a realistic view of people, as opposed to extremist anthropological utopias which arise from an exaggerated belief of people in themselves and their capabilities.

Modern conservatism as a middle-of-the-road position is therefore no longer conceivable without a Christian or humanist anthropology (Doctrine of Man; →*Thielecke*) and as the basis for a critical awareness of history, a personal ethical commitment to duty and responsibility, a sense of family and community, a love of nature and envi-

ronmental responsibility, a focus on public welfare and political morality and a 'constitutional patriotism' (D. Sternberger).

This leads on to the 'spiritual' claim of modern conservatism and its guiding force for the future in an era of individualistic hedonism (a life focused on personal pleasure), the materialistic dedication to consumption and the immoderateness and permissiveness of the media. In almost every aspect of life today a frightening lack of direction can be observed, without churches, schools or political parties being considered as sources of meaning because they are themselves searching for guidance and understanding, and have no answers to the burning questions of the day. A loss of authority results, which has a negative effect even on politics, parties and the state.

The 'political' claim results, on the one hand, from the increasingly progressive conservative outlook: principles of responsibility such as provision for the future (e.g. in the health service), sustainability (in ecology), fairness (regarding social reforms and rates of pay) and subsidiarity (e.g. in the federal allocation of authority from the municipalities to the federal states, and countries to the European Union) combine the conserving and the creative strength of conservatism.

On the other hand, the global aspect of political and economic relationships today requires a reliable understanding of the complex conditions of existence by thinking interdependently (mutual dependence; →*Eucken*), as well as the protection of '→*competition* as a mechanism of discovery' without 'arrogance of knowledge' (Friedrich August von

→Hayek), as an engine of social and economic development in a global world.

Today, such a programme can only be mastered by reaching beyond the borders of political parties. This renewal of democracy and the →social market economy through the spirit of conservatism is indispensable in view of the great challenges of the future.

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Klaus Weigelt

## Constructivism

### *The problem: Possibilities and limitations of political acting in modern societies*

The term 'constructivism' emerged from the capitalism→socialism debate of the last two centuries. There, those defending a liberal position raised the objection against the suggestions of mostly socialist authors in support of an engineered society, that societies cannot be planned, either as a whole or in important parts.

The leanings which have been called constructivist are characterised by a great deal of confidence in government behaviour, as for example when supplying important goods and services or through the solution of complex social problems. Important tools of the 'state of welfare provision' are the

bureaucratic system, national planning and the practice of coercion, in order to realise policy goals and the endorsement of collective solutions.

The critics of constructivism argue against this organising principle saying that:

- the human faculties of understanding are finite, which closely limits attempts at social planning;
- important social institutions are not purposefully created but are the result of unplanned human interaction and resist further development through intentional planning; and
- attempts to make comprehensive social planning a reality not only failed to achieve the goal they had propagated but also through increasing restrictions on individual freedom, frequently ended in dictatorship.

Unlike the constructivist school of thought, its critics prefer competition to planning and decentralisation to centralisation, and they defend voluntary coordination against central control.

Among the critics of constructivism are the early members of the Scottish school of moral philosophy, starting with Adam Smith (1723–1790) and David Hume (1711–1776), but also the newer liberal authors such as Friedrich August von →Hayek (1899–1992), the continental neo-liberals and the contemporary Anglo-Saxon classical liberals. What they all have in common is that they place a great deal of confidence in liberal forms of human co-existence and in the spontaneous forces of an open society.

In fact, the debate around constructivism is not an ideological question but a basic problem of the economy and social sciences. Does human society allow itself to be manipulated and controlled just like the physical world? In other words, can the modern, technical and scientific way of thinking be transferred to social problems with equal success? Can, for example, the 'visible hand' of the state steer the economic process in such a way that fluctuations and crises, the terror of all free market societies, will soon be a thing of the past?

#### *The older constructivism*

There is a marked disparity of opinion on the development of economic doctrine. Adam Smith and his intellectual successors delineate the sphere where social engineering is permissible very closely, despite attributing a number of important public tasks to the state as political player. Early socialists such as Auguste Comte (1798–1857) and Henri de Saint-Simon (1760–1825), however, postulated that all the members of a social system must pursue a 'common goal', which consists of a 'plan for social progress'. This is, however, not designed by those concerned but by scholars credited with the ability to predict the future development of society accurately (Fehlbaum).

Finally, Karl Marx (1818–1883) was of the opinion that the historical collapse of capitalism must inevitably lead to a 'realm of freedom' and thus to a new society. The failure of this prognosis after the socialist revolution in Russia (1917) had the consequence that the founders of the Soviet Union decided on the forced implementation

of the communist social ideal. Mao Tse-Tung, Pol Pot and numerous other dictators later followed this example in the sense that they justified the elimination of entire classes and strata of society with the argument of wanting to create a new society (Courtois).

#### *The newer constructivism*

The newer constructivism goes back to the aftermath of the First World War (1914–1918) and the consequences of the world economic crisis (1929–1938). Both events were interpreted as proof that the old liberal order, which had been ubiquitous throughout the Western world during the 19th century, had failed.

The liberal social philosophy was replaced by the social or welfare state and the belief in an all-encompassing, non-socialist economic order. The idea was to transform the social order of the time democratically, and on the basis of the criteria of social equality and social justice. This meant, for example, that education and training policies were to create equal chances for all, that different levels of income were to be evened out by progressive taxation, that the same medical care for all would be guaranteed through compulsory insurance schemes, and that the dependence of the individual on family support was to be replaced by governmental security and welfare systems.

#### *On the critique of constructivism*

The critique of both varieties of constructivism tends to be based on principles of value. The more radical models have been dismissed as utopian. The newer critique of constructivism, however, takes a different path. It makes use

of epistemological and specialised scientific objections to demonstrate the limitations of political acting in a free society.

The liberal critique of constructivism is based on the maxim 'Where there is a will there is a way'. Social goals which rest on an unrealistic concept of human nature cannot but fail. Those who consider social engineering as the way forward for social relationships are opposed by the critics of constructivism who see social processes in the light of evolution. This means that the most important institutions of human civilisation – such as language, law, arts, science, ethics, customs, the division of labour or the markets – are not the result of purposeful human planning but grow out of human interactions with no special intention or plan.

Adam Smith's concept of the 'invisible hand' and/or the idea of self-control or self-organisation of social institutions clarify this world view. The institutions mentioned here can neither be consciously designed nor can they be successfully developed further by conscious design. In those areas where – for instance in art, science or ethics – political control along the lines of preconceived political ideals is attempted, intellectual stagnation and the birth of social illusions are the consequence.

### ***The evolutionary versus the static view of society***

The older conceptualisations of a 'new society' are usually linked with the promise of a permanently valid and eternally fair social order. This gives them a static quality. However, four arguments can be derived from the evolutionary view of social processes.

- Political attempts to achieve the total restructuring of an existing social order encounter the difficulty that, in each case, the society in its current state was shaped by a long series of preceding events. They have left their mark in traditional rules, behaviours and attitudes, of which the subjects are either not or only partly conscious or aware (Hayek). Where rules are 'discovered', they are definitely not comparable to the inflexible laws of natural science. This is also made evident by the fact that until today, in the social realm, no 'social laws' comparable to the laws of nature exist. All attempts to establish them have failed. In other words, the social sciences are not (or not yet?) in possession of a well-tested body of empirical knowledge that allows them to make the sort of progress which modern technical knowledge manifests almost daily.
- The 'economy' and the 'society' are extremely complex phenomena that cannot just be understood from the point of view of control (or at least not sufficiently). The attempt, first in the Soviet Union and in many other countries thereafter, to replace the traditional way of coordinating individualised economic planning with centrally managed markets, represents a crucial large-scale experiment. The expectation was that the outcome would be a successfully functioning economy, far superior to the alleged 'chaos of the markets' in just about every respect. This experiment failed though, not least because of the impossibility of even trying to centrally coordinate the highly complex

network of input and output between enterprises in a satisfactory manner. Constant interruptions to the production process 'due to lack of materials' were a daily occurrence. It is therefore not surprising that where central economic planning has been forced to survive to the present day (Cuba, North Korea), the standard of living of large parts of the population has plummeted to below minimum subsistence levels.

- Large-scale social experiments (such as the design of a new society) are faced with the problem that controlling the successes leading to the new society becomes a political issue. Compared with more gradual and limited reforms, which make it possible for open societies to learn from mistakes (Popper), the plan to establish a completely new society is a process which makes it uncommonly difficult and even dangerous to point out mistakes or voice criticism. All human institutions have shortcomings. If these manifest themselves in the form of planning failure or the typical 'economy of scarcity', then one must ask what the reasons are. Since the revolutionary restructuring of existing social orders can be politically justified only with the argument that it will lead to a better world, system failures have to be blamed on 'enemies' – be they class enemies, deviants, dissidents or foreign agents. If anyone makes the allegation that the new system has inherent mechanical defects, he/she is automatically suspected of being an enemy of the state. This eliminates the process of trial and error (the method of trying

new possibilities while correcting mistakes along the way), which has been an important mechanism driving human progress. The total collapse of 1989–1991, which put an end to these policies in the socialist countries, is hardly surprising.

- The hope that planning leads to success and that social engineers can create a better world is usually linked with the concept that there is an enlightened elite, an avant-garde of the proletariat, an infallible party or a leader loved by the people, able to point out the right way into the future. None of the expectations that the older social planners cherished was as thoroughly disproved by experience as these. The more recent history of the Eastern and Southern dictatorships shows unmistakably that the governing autocrats and their followers generally make personal gain the first purpose of their rule. The promise of a higher standard of living for the broad population is only relevant if the security of their respective positions of power is at stake.

### ***Interventionism and constructivism***

In view of the fact that nearly all socialist societies have collapsed in the past two decades, the idea of wanting to create a completely new society is today more or less extinct.

It has been widely accepted that one is dealing with a utopian concept here or – in terms of the present topic – that the necessary knowledge and means for the implementation of a socialist centrally planned economy and society do not exist. This is why it is relevant to ask the question whether the same

applies to the models of the welfare state that have succeeded socialism. They are characterised by the fact that regulations are put in place in key areas of human life which the individual citizen can evade only with great difficulty, if at all. The national monopolies which have been created for this purpose to provide for retirement, health care, education or access to the job market are not only a danger to individual liberty but, in terms of a critique of constructivism, must be seen as solutions that are not viable at the end of the day and that are not able to cope with the tasks they have been assigned. One example is the constructivist-collectivist solution in terms of which →old-age pensions are organised in most welfare states. This is one way of proving that, without fail, 'century laws' have to be revised at short intervals.

A plausible explanation why the so-called reforms have never succeeded is the large number of unknown or unforeseeable variables, which quickly render every previous forecast obsolete. The situation is similar for the health service, or the government unemployment agencies, or the attempts to largely eliminate crises and fluctuations of the economy by following Keynes's prescriptions. Even the public education system – which is much more transparent and which despite certain moves towards liberalisation remains subject to government dictates – does not come close to achieving the results which elsewhere, in less regulated education systems more exposed to competition, are the norm.

In terms of the critique of constructivism, however, the main defect of constructivist solutions lies in the fact

that, unlike liberal solutions, they either make it much harder or completely impossible to try out alternatives, to experiment with new solutions and to learn from experience. The only way to implement changes is through the slow political channels, with the consequence that the compromises that have been achieved through the political process are what matters, rather than the issue at stake. The critics of the constructivist doctrine therefore want the state to extricate itself from many of the numerous commitments that it has taken on in the course of the past eight decades.

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Christian Watrin

## Consumer policy

Competition connects production and service with consumer interests. Three

key arguments have long been held against the theory of the sovereignty of the consumer.

As well as in the past, these arguments are nowadays also frequently used to justify government interventions today, above all, by the European Commission:

- *One has to be thoroughly informed about the products on offer.* Thanks to the internet, this condition is fulfilled.
- *Marketing, and in particular advertising, manipulates the consumer.* This thesis has been disproved by social psychology. The theory of in-built obsolescence is equally disprovable.
- *Markets only partly take consumer interests into account and are not suited to the provision of public utilities.* The opening of government-controlled markets like telecommunications to *→competition* shows that markets are better able to satisfy consumer interests than government control.

Nevertheless, governmental competition policies are not enough for consumer interests to have the desired effect. There are goods that we require but that are not marketable. Here, the exclusion principle does not apply or only to a limited extent. The exclusion principle means that when we use a commodity alone, we can exclude others from its use. It applies to cars and furniture but not to, for example, internal and external defence and flood protection. These goods are called 'infrastructure'. This term is more precise than the fuzzy term of 'provision for one's daily existence', which might sim-

ply serve as an excuse for the government to engage in interventions that are not in synch with the market. In the case of services pertaining to infrastructure, we need to examine which task the government should actually perform. It may entail securing the supply, the funding or, as the example of *→education funding* demonstrates most clearly, the distribution.

The legal aspect of *→supply and demand* is the contract. The government has the duty to guarantee the prerequisite 'freedom of contract'. This also means that the consumer must be assured through a warranty that the acquired products actually have the promised characteristics. Sales contracts have to be exclusively based on free declarations of intention. This applies to hawkers just as much as for telesales.

Through product requirements, the government has to protect the public against health risks of which they cannot be aware. This applies to materials in food which are harmful to health and to unsafe technical gadgets. This cannot apply if health hazards are obvious, as they are for smoking. Product prohibitions or large compensation claims for general risks that are commonsense are opposed to consumer sovereignty. To give consumers the chance to choose, they must be informed about the ingredients of foodstuffs and luxuries, the material composition of goods, as well as the resource consumption of technical aggregates.

Product information should become a compulsory requirement for suppliers. General consumer information, quality information through comparative goods testing and consumer counselling, however, are useful and

valuable services for the consumer – services that can be, and are, requested and offered in the markets. There is no reason for government intervention.

If, despite a functional competitive policy and sufficient consumer protection laws, consumers are still unhappy with their market position, they are entitled to form an organisation. The consumer protection movement in the United States and the reactions of consumers in Germany to information about enterprises' environmentally damaging or exploitative practices show that consumers can be a force to be reckoned with.

Apart from the legal entitlement to information and protection which has already been mentioned, the most effective consumer policy is an understanding of economics. Consumers who understand how a market economy works, automatically also know how they can exert pressure and how they can enforce consumer interests.

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*Wolfgang Reeder*

### **Council of Experts**

The Council of Experts for the assessment of the economy was created by legislation in 1963. Its task is to draw up regular reports on the state of the economy and on developments in Germany for the foreseeable future. This is meant to make it easier for the authorities in

charge of economic policy, but also for the general public, to form an opinion. The council produces annual and special reports. The annual reports examine different ways of fulfilling economic goals within the framework of a market economy.

From the point of view of the general economy, these goals are →*price level stability*, a high level of →*employment* and a →*balance of payments equilibrium* combined with appropriate →*growth*. Besides that, the Council of Experts is supposed to identify erroneous trends and to indicate ways of preventing or eliminating them without, however, recommending specific measures (recommendation prohibition).

The council is exclusively bound by its contractual appointment. In its activities, it is independent of government directives. In this respect, it differs significantly from advisory committees in other countries (the Council of Economic Advisors in the United States does its government's groundwork). If the Council of Experts identifies erroneous trends in individual areas or if it is appointed by the federal government to do so, it may or it may be required to provide an additional report (special report).

During the early years of the council's existence, issues related to economic stability were the priority. The influence of →*Keynesianism* put special emphasis on the question of how macroeconomic goals could best be achieved. But when it became clear that this was not the right political approach for the solution of urgent macroeconomic problems such as high →*unemployment*, questions of →*institutional order policy* became key. Thus in its 1996



annual report, the Council of Experts presented a comprehensive analysis, pointing out weaknesses in crucial areas of the social security system (the public →health insurance, →pension and unemployment insurance) and indicating possible approaches to reform. This was a stimulus for the political debate in these areas. In its 2000 annual report, the current reforms in the sphere of old-age provision underwent a critical analysis, while reform strategies were suggested before the background of imminent reforms in the health system. In its 2003 annual report, the Council of Experts supported the transition from the synthetic to the dual income tax system and a lowering of the tax rate. Demands for reforms of the labour market, however, are the central theme of the reports.

The Council of Experts consists of five members ('five wise men'), who are appointed for five years by the Federal President after nomination by the federal government. Every year, the term of office of one of the council members runs out, but reappointments are permissible. In order to preserve the impartiality of the council, its members may not be part of the government, a trade association or a workers' or employers' organisation.

Each time a vacancy has to be filled, however, the trade unions and the employers can make use of their informal right to suggest a candidate, usually to guarantee the acceptance of the annual report by the interest groups. If the council does not succeed in agreeing on a certain question, individual members are entitled to express their differing opinions in the report (minority votes).

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Martin Wölborg

## Currency system and exchange rate regimes

In theory, exchange rate regimes can be divided into two extremes: systems with completely flexible exchange rates and systems with completely fixed exchange rates.

Complete flexibility means that there is no direct intervention from the central banks in the price formation process on the foreign exchange markets through buying and selling currencies. Then the exchange rates can form freely according to →supply and demand ('floating').

Completely fixed exchange rates result if the central banks keep the exchange rates constant at a certain level through potentially unlimited buying and selling of currencies, or if the rates have been irrevocably fixed by political authorities.

Between these two extremes, there are systems with more or less flexible exchange rates: managed floating, fixed exchange rates with range and exchange rates with or without range with graded flexibility. Managed floating means that central banks influence flexible exchange rates through interventions at their current level.

In the case of fixed exchange rates with range, a parity level between two currencies is fixed, but the exchange rate can fluctuate around parity within a certain range either upward or down (e.g. around  $\pm 2.25\%$ ). If the exchange rate reaches either the upper or lower limit of the range, the central bank is forced to intervene, but alternatively it can intervene – intra-marginally – before a limit has been reached.

An exchange rate system with graded flexibility has a fixed parity level – with or without range, but occasionally, due to new foreign exchange market conditions, this is adjusted to a new level (revaluation or devaluation).

Closely related to this is the crawling peg, where a country increases or decreases the exchange rate in instalments – usually with warning: e.g. around 1% per month, taking into account the inflation gap between the two countries. Block floating is a combination of fixed and flexible exchange rates, where several countries adopt a fixed exchange rate while jointly practising exchange rate flexibility in relation to third currencies ('currency snake'). The flexibility of the block exchange rate can also be limited to a certain range ('snake in the tunnel').

While the gold standard (used mostly before the First World War) was really a system of fixed exchange rates, the

world monetary system since the Second World War – the Bretton Woods system, conceived in 1944 before collapsing in 1973 – was handled as an exchange rate system with graded flexibility. The same basically applied to the European Monetary System which was in force from 1979 until the introduction of the European Monetary Union on 1 January 1999. Otherwise, a global system of managed floating has been in existence since 1973.

Nevertheless, a number of different countries link their currency to an anchor currency or a currency basket with a fixed exchange rate. The strictest link is the currency board, where the central bank of the linked country will arrange the national money supply exclusively on the basis of the stock of its anchor currency.

A country that has several currencies co-existing, officially or unofficially, as legal tender with exchange rates that are flexible has a competitive monetary system. A special development is the parallel currency system, where there is only one competing currency.

The currency of a country is called fully convertible when it is not subject to any capital movement restrictions, i.e. if the currency can be imported and exported without any restrictions by residents and foreigners.

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*Wolf Schäfer*

## Demographic development

### Facts

The 20th century will be recorded as the century with the largest population increase in the history of mankind. If the world population around 1900 totalled just over 1.5 billion people, by 1950 it had grown to 2.5 billion. By the end of the century, our planet was populated by more than 6 billion people. What used to take several thousand years in terms of the multiplication of the population, took just a few decades in the 20th century.

### *Growing world population ...*

The population increase will continue in this century, too, but at a slower rate. According to United Nations (UN) estimates, there could be in excess of 8 billion people in 2030, and this could have increased to approximately 9 billion by 2050. This figure is a far cry from the prophecies of doom which had predicted a population explosion. But it nevertheless represents an enormous challenge, because 3 billion more people will demand more water, food, energy and raw materials. And yet, decreasing natural resources and increasing ecological problems are less the result of the global population growth than the consequence of individual production and consumer behaviour.

### *... shrinking population in Europe*

In Germany and the other Organisation for Economic Cooperation and Development countries in Europe and North America, population growth has ceased to be an issue. On the contrary, a population decrease is imminent. If

there are about 82 million people in Germany today, there might be fewer than 80 million in about 2025 and only 70 to 75 million by 2050, depending on the estimated number of immigrants (→*international migrations*).

### Causes

Only two independent variables have a direct impact on population development: birth rate (fertility) and number of deaths (mortality). For the national population sizes the (international) migration balance has to be added as a third, unknown quantity.

### *Many births and decreasing mortality outside Europe ...*

The dynamic growth of the world population in the 20th century can basically be attributed to an utterly simple equation: the number of births far exceeded the number of deaths. The question that remains is: what led to this gap between fertility and mortality? Here, the first thing to consider is demographic transformation. Thus the mortality decrease is mainly seen as a consequence of improved medical care, hygiene and economic living conditions in Africa, Asia and Latin America, followed only much later by a slowing birth rate. This caused the relatively great differences between births and deaths.

The high birth rates of the recent past in Africa, Asia and Latin America have led to an age distribution with a relatively large proportion of young women in their reproductive years or growing into them. Even if from today onwards, hypothetically and for whatever reasons, fertility were to shrink significantly (e.g. to two children per fam-

ily), the populations of these regions would still keep on growing for a very long time. These dynamics inherent in population trends will continue to generate a strongly positive growth rate of the population for several decades to come.

*... strong decline of the birth-rate and growing life expectancy in Europe*

Since the mid-1960s, the birth rate in the industrialised states has been declining. Germany is no exception. Since the peak of the baby boom in the middle of the 1960s, fertility has declined markedly.

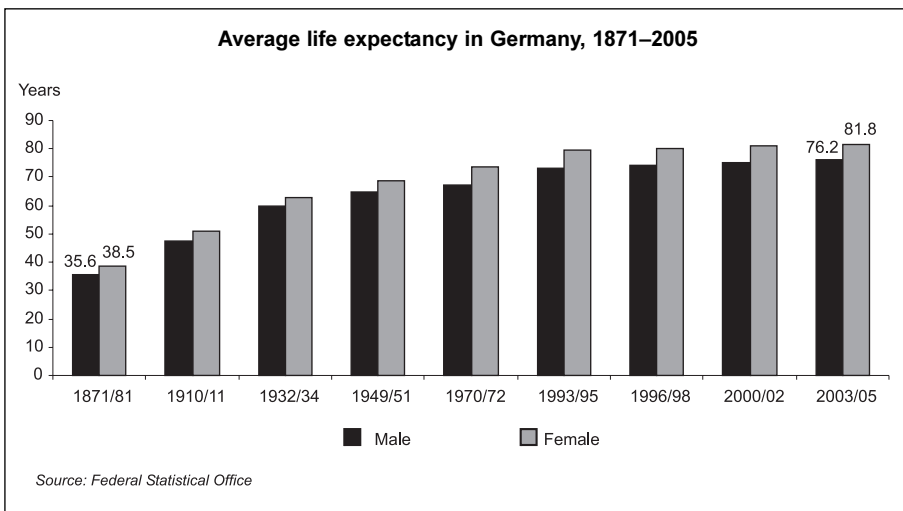
In 1965, in the course of their lives, 100 women living in Germany gave birth to an average of about 250 children. Within a decade (i.e. by 1975) the birth rate went down to fewer than 150 children. Since that time, this number has continued to decrease – rather dramatically after the German →reunification because, particularly in the new German states, the desire to have children went into a notable decline. In 1998 in Germany, 100 women were on

average giving birth to 133 children – one half of the number one generation earlier.

The net reproduction rate (NRR) measures the number of girls born alive, to whom 100 women of the same generation have given birth. A NRR of 100 means that the status of a population remains constant, because a generation of women has just been ‘replaced’ by the daughters to whom they gave birth. A NRR <100 (>100) means that a population shrinks (rises). A NRR of 70, for example, means that within one generation, a population has shrunk by about 30%.

For Germany, in 1960, the NRR was 110; in 1975 it was 68; in 1990 70; in 1998 it was about 66; and in 2005 it was 64, which means that within the next generation the German population will shrink by approximately one third.

The reasons for the declining birth rate are not found in any singular key event. This means that the thesis of the ‘pill kink’ is untenable. While contraception does lead to a decrease in unwanted births, its availability repre-



sents only an option and not the cause of the declining birth rate. It is not the availability of contraception which is crucial, but the intention of using it.

More relevant for the explanation of a declining birth rate might be the change of function of the family, the new way women see their role (emancipation) or the individualisation of society.

Today, the desire to have children is more strongly linked to the individual interests of both partners. The fact that children are 'expensive', reinforces the trend towards small and micro-families. And here the problem is not only direct expenditure, but also indirect (time) expenditure, which means that children stand in the way of professional (career) opportunities being realised.

In Germany, the 20th century gave rise to a marked increase in life expectancy (*see figure*). In 1871, at birth, life expectancy was 36 years for boys and 38 years for girls. By 1910, it had climbed to 45 years for boys and 48 years for girls. Someone who was born in 1998 can expect to reach the age of 74 for men or over 80 for women, and in 2005 life expectancy was 76.7 for boys and 82 for girls. Mortality, particularly during the first year of life and between the ages of 60 and 80, has decreased considerably. According to present-day medical knowledge, a further mortality decrease this century will proceed at a much slower pace. The formula for eternal life has still not been found, which means that even in the 20th century the maximum life span could only be extended slightly.

### **Consequences**

The contraction of the population in

Europe is generating enormous problems which result from the changed age configuration of the population. Children are decreasing in number, while the number of elderly and old Germans, and other Europeans, is rising. The result is an ageing German and European population.

If today still more than half of the German population are less than 40 years old, by 2050 this median age will have risen by about 10 years. By the middle of the century, half of all people living in Germany will be older than 50.

The ageing of a society can be clearly illustrated with the so-called age quotient. The age quotient (AQ) gives the proportion of pensioners at the age of 65 or older to the employable population between 15 and 64.

An AQ of 0.5 means that there are two employable people per pensioner, or twice as many working people as pensioners. A rising AQ shows that for each pensioner, there are fewer and fewer employable people.

With an AQ of one, there are as many pensioners as employed people. For Germany the AQ has the following values: 1991: 0.22; 2000: 0.23; 2020: 0.32; 2040: 0.48. This means that instead of the four working Germans per retired citizen, in 40 years there will only be two.

### *Macroeconomic consequences of the demographic ageing of Europe*

Hardly any sphere of the modern service society will be spared the consequences of ageing. In the first place, there will be a change in the supply of labour. A dwindling number of young workers will be available to replace the senior workers preparing to leave the

production process. Today's problem of  $\rightarrow$ unemployment is partly palliated by demographic processes. It cannot be excluded that even a lack of younger, efficient workers might arise, which could then be remedied in different ways, for example:

- making use of resources which are lying dormant today (above all women and individuals in early retirement);
- making retirement age flexible, also upwards (e.g. later retirement in line with a higher life expectancy which continues to rise);
- higher levels of immigration (particularly of younger qualified workers); and
- accelerated (labour-saving) progress of productivity.

In short, particularly the demographic development will make it necessary for more women and more people over retiring age to be included as a resource of labour and know-how.

#### *How safe are retirement pensions?*

In the medium term the ageing (German) society will be confronted with problems regarding  $\rightarrow$ pensions. In Germany, as in almost all other European countries, pension systems are largely based on a national system of statutory insurance contributions, organised on a pay-as-you-go basis (current disbursement).

In a distribution system, the regular contributions made by the active workforce to a retirement fund cover the

pension pay-outs for those who are no longer working. In simplified form, the following pension formula applies: the sum of the contributions (= number of payments  $\times$  by the average rate of contribution  $\times$  by the average income) must correspond to the sum of the disbursements (= number of pensioners  $\times$  by the average pension category,  $\times$  by the average last earned income).

Pay-as-you-go based systems are rather susceptible to changes in the age structure of a population. The German population is living to an older age, which in terms of the pension formula means that while the number of contributors is declining, there is also a growing number of people entitled to a pension. Therefore, either the average rates of contribution must be increased or the average pension disbursements will have to be reduced (a third solution would be the uneven distribution of future productivity advances).

It seems to be becoming increasingly unavoidable to supplement the long-standing pension insurance scheme with an additional second column (legal, national, mandatory) based on individual provisions (e.g. private savings).

Immigration represents another potential solution whose effect, however, tends to be overrated. Depending on the forecast, annual immigration ratios of several hundreds of thousands of people would be necessary in order to be able to keep the AQ at today's level. Furthermore, the immigration effects are only temporary, since the immigrants too will sooner or later have claims against the pension system which they have helped to finance ( $\rightarrow$ old age pensions).

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Thomas Straubhaar

## Deregulation

Deregulation is about the politics of opening markets. It is instrumental in the removal of regulations, which the state or, with its agreement, federations and professional organisations have introduced in favour of certain groupings of workers – for example, limitations on market entry and exit (→*open markets*), price and quantity regulations and compelling contract designs. In addition, there are specifically targeted exemptions from the general trust prohibition and special privileges for →*public enterprises*.

This sort of targeted interference with the freedom of trade is only economically justified in a case of market or competition failure. This can, among other things, happen in the case of external effects of production and in consumption, in natural monopolies and in cases of information asymmetries (unequal status of information) between contracting parties. In these cases the situation would, without adjustment, get out of hand.

In reality, market anomalies of this kind tend to be rare and a surplus of regulations is more of a problem. The

result is economic sclerosis and inefficiencies, which are detrimental to prosperity, growth and unemployment.

Until the 1990s, half of the German economy, particularly in the service industries, was more or less strictly regulated. This also applies to the job market even today (collective blanket wage agreements, excessive worker protection laws, far-reaching worker →*co-determination* regulations in companies) with correspondingly severe disruptions and high levels of long-term unemployment as a consequence.

In recent years, however, regulations have been phased out, usually in connection with the completion of the European domestic market. The telecommunications, air transport and electric power industries are the most prominent examples.

Deregulation is not always about doing away with existing regulations entirely; at times it is sufficient to soften or modify them. But regulations which have become superfluous or always were superfluous must be abolished. This also applies in cases where the purpose of a regulation clearly does not justify its cost to the economy as a whole, especially if allocation distortions have been the result.

In macroeconomic terms, deregulation promises five lasting advantages:

- As the popular saying goes, competition promotes business. A producer who wants to make profits will have to try hard to boost the productivity of business while keeping costs and prices low, as well as bringing attractive goods and services to the market.
- More room for profitable economic

activity leads to higher productivity, and more productivity results in a greater demand for labour.

- Flexible markets facilitate the adjustment process for both industry and the workforce to the age of →*globalisation* and the internet, and to the profound structural economic changes it brings. A brisk structural change promotes growth and favours employment.
- The positive employment effects are reinforced by measures which increase the flexibility of the goods markets, if there is a liberalisation of the labour market too. This means that the parties to a wage agreement not only have to pay more attention to the remuneration agreement itself, but also to the other conditions of employment. Wage levels need to be in line with market conditions and they must also be sufficiently differentiated in terms of regional differences and different levels of qualification. This creates an environment where obstacles to employment for job-seekers are reduced and where it becomes less rewarding for them to resort to the →*shadow economy*.
- It means that the internationally mobile factors of production can count on more attractive returns, with the result that the entire country becomes more desirable as a location for both investment and industry. Capital equipment and skilled labour flow into the country instead of leaving it, boosting its economy as a whole and expanding its productive capacity.

The more stable the foundations on which they are built, the more lasting the positive effects of the policy of deregulation will be. Obviously, there will also be negative effects here and there. Basically, there will be disadvantages for those who were hitherto protected against →*competition* by special regulations. But owing to the intensified macroeconomic dynamics which a comprehensive deregulation liberates, these disadvantages will mostly be temporary.

For maximum effectiveness, deregulation requires safeguards in three areas:

- A safeguard is needed in respect of the simplification and acceleration of legal and administrative authorisation procedures which are relevant for investments and business start-ups.
- It should always be checked whether an existing law, a legal requirement or an administrative regulation should either remain in force or be phased out. An over-abundance of regulations is extremely counterproductive for an economy and tempts people to break the law.
- Deregulation must be based on the consistent application of the competition protection laws in order to prevent both cartel agreements among those who were previously regulated, and the abuse of power by the supplier to the detriment of the consumer. This is why, for example, in the case of the telecommunications deregulation it became necessary to regulate the former monopoly in an asymmetrical fashion in its various different



areas of application (tariffs for fixed-line telephone calls; becoming a Telekom subscriber), in order first to kick-start and then step up competition through additional service providers. These regulations can be phased out as soon as there is enough competition in the end-consumer markets, something which should be determined by an impartial authority such as the →*Federal Cartel Office* in Germany.

Constitutive regulations are not part of deregulation. These apply to everyone and safeguard – particularly in the context of civil law – the functionality of the →*social market economy*.

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Juergen B. Donges

## Development aid, development policy

The term 'development policy' covers all measures that are implemented to improve the level of development of underdeveloped nations. If the level of development of a country is regarded as being intolerably far behind that of the industrialised nations, it is generally called a developing country. This defi-

nition primarily refers to the aspect of satisfaction of needs.

The standard of living, i.e. the opportunities people have for satisfying their needs, are very much smaller in developing countries than in industrialised countries. The per capita income level is usually selected as an indicator of the standard of living.

Many people in developing countries live in abject poverty and are not able, with their available per capita income, to satisfy their basic needs. Basic needs are things like sufficient nutrition, shelter and clothing, as well as access to education and public health services, drinking water and public transport.

The most important development policy goal is to increase the standard of living in developing countries, particularly for the poor population groups. In addition, development policy measures have economic, political and social aims.

From an economic perspective, development policies are focused on three targets: the most basic prerequisite for a better standard of living is an improved supply of goods thanks to economic →*growth* (growth target). Second, improved goods distribution in order to ensure the maximum satisfaction of needs for the population. This requires the reduction of abject poverty and a diminished income concentration in nearly all developing countries (distribution target). Third, a permanently improved standard of living presupposes that the environmental effects of human activities are taken into account. This means that the development policy agenda must include an →*environmental target*.

For the implementation of the targets listed here, a stable political, social and economic framework is indispensable. In many developing countries, the absence of such a framework is the greatest obstacle to development. Apart from the establishment of stable basic conditions, the main focal points of economic development policy are the promotion of real capital formation, better education and health conditions of the entire population, the development of the infrastructure, as well as the establishment of important institutions (among other things, financial institutions and social security systems).

While development policy refers to the full range of measures which further the development of a country, the term development assistance implies measures that a foreign country takes to support the development process of underdeveloped countries and which would not be thinkable in their specific form without the concept of aid (e.g. interest-free credit).

Nowadays, development aid tends to be called development cooperation, and it is divided in various ways. Depending on the nature and origin of the aid, a distinction is made between bilateral and multilateral cooperation. In bilateral cooperation, aid comes from an individual donor country. In multilateral cooperation, it comes from a group of donor countries or →*international organisations* (the World Bank, International Monetary Fund – IMF).

At an operational level, one differentiates between financial, personal and technical cooperation. Regarding financial cooperation, capital is put at the disposal of developing countries under special conditions. This capital usually

takes the form of soft loans. Personal cooperation offers →*vocational training and further education* to produce highly skilled staff in leading positions who are expected to bring about a higher educational standard in developing countries.

Technical cooperation offers technologies as well as organisational and economic know-how and skills to developing countries. All three forms of cooperation complement one another.

Often, development cooperation also makes a difference between programme and project aid. While project aid is directly aimed at certain activities (e.g. the construction of roads), programme aid is intended for the support of specific areas and macroeconomic reform programmes. How the means are used is up to the target country in this case, but their disbursement is normally tied to certain conditions (usually the implementation of reforms) (conditionality).

The best-known form of programme assistance comes in the form of the structural adjustment programmes of the IMF and the World Bank. Here, a country, in agreement with the respective donor institution, decides on a free market reform programme whose implementation is supported by structural adjustment loans.

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*Hans-Rimbert Hemmer*

## Distribution

The distribution of  $\rightarrow$ income among people always brings up the question of what is 'fair' distribution. What exactly constitutes fair distribution cannot be precisely determined either through science or politics. Criteria and objectives are required. Where they come from and how they can be explained depends on the basic political structure of the society concerned. In Germany, a crucial part of the design is the  $\rightarrow$ social market economy.

In the  $\rightarrow$ market economy, the relationship between  $\rightarrow$ supply and demand determines the price of labour and the employment of capital, and thus the personal distribution of work and capital income. This is why the  $\rightarrow$ achievement principle is the most important yardstick for income distribution.

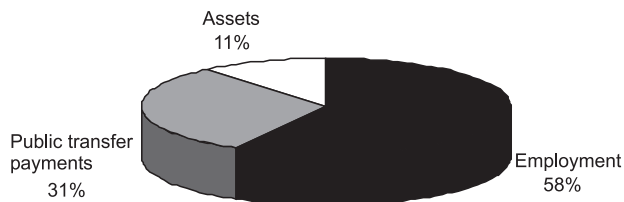
This principle states that the total income of the economy has to be divided among the economic agents in proportion to the personal performance which they have contributed by employing capital and work. Everyone is to be remunerated in accordance with their achievement. This is the 'justice of

distribution'. It implies that differences in service quality justify unequal income levels among people.

The remuneration, which is left to the market forces, also liberates performance incentives which drive economic  $\rightarrow$ growth and technical progress. If a significant proportion of the profit that can be made in the free market is obviated through government intervention or the income-earner is subsequently deprived of it through taxes, the personal desire to perform is weakened. The consequences are misdirected capital, for example, to a foreign country or into illicit work, causing lost productivity and weakening economic growth. The adherence to the efficiency principle requires that all market participants are assured of equal opportunities. Every human being has to be given the chance to develop the talents which secure him/her an  $\rightarrow$ income in the job market, through appropriate training. Besides, a reciprocal effect results from the fair distribution of capital assets.

However, even if these standards are laid down by the national  $\rightarrow$ institutional order policy, there will always be people who are not able to earn a satisfactory

**Average gross private household income in Germany in 2003 (€3,561)  
earned by assets, employment and public transfer payments**



Source: Federal Statistical Office: EVS 2003 – Survey of income and expenditure

living through their own individual achievements. A person's earning power may be limited by an inability to work or by illness or incapacity, or it may not be able to be realised due to undeserved →*unemployment*. There is therefore political consensus on the need for everyone to be guaranteed a minimum income.

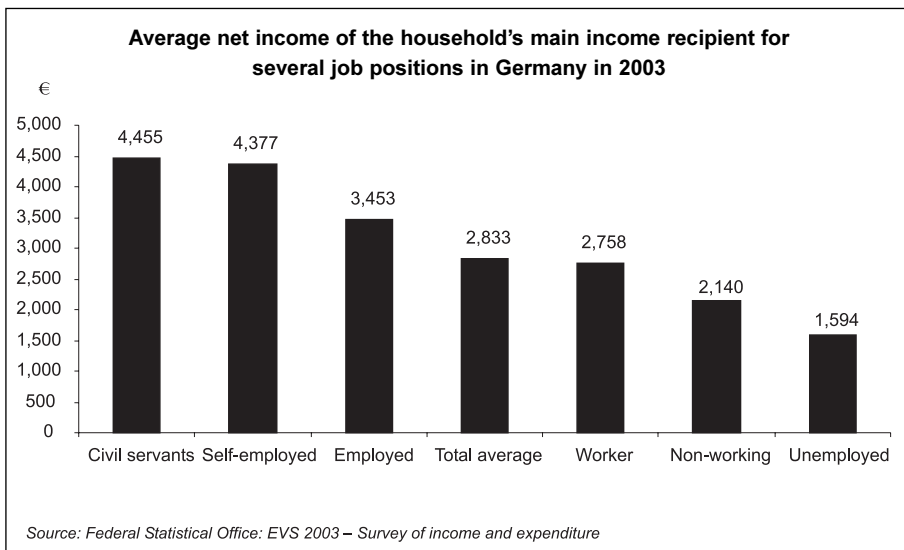
The principle of performance is thus complemented by the right to a living wage. This right is an expression of the equality principle, which postulates that all human beings are equal. However, a rigorous application of this principle in the form of an absolutely equal income distribution would eliminate the principle of efficiency and would lower the welfare of all economic subjects drastically.

In trying to determine the subsistence level, a distinction is made between the physical and the cultural component. The physical subsistence level covers all material goods which are necessary for survival (food, clothes, shelter). The cultural subsistence level

is supposed to make a certain degree of participation in a social life possible. Opinions regarding the monetary value of the subsistence level differ substantially. The efficiency principle requires that the guaranteed minimum income must not undermine the desire to perform in the sense that it is no longer worthwhile to offer one's earning capacity on the labour market.

The right to a subsistence level is extended by the 'principle of need', which means that the distribution of income must suit the unequal needs of the economic agents. It is impossible to reach a universal agreement on this issue. An assessment is possible only through dealing with the concrete problems which approach subsistence level. A case in point is increased need due to family members. What proportion of this has to be borne by society is a very controversial matter.

The principle of need interpreted in this way, and the right to a subsistence level, require an income distribution policy which takes effect via income tax



and income transfers. These government distribution procedures turn the primary distribution which results from the achievement principle into a secondary distribution. This is an expression of the solidarity aspect of the social market economy.

When assessing its redistribution policies, the →social market economy should give preference to the achievement principle for the sake of long-term prosperity.

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## Economic ethics

Economic ethics are concerned with the question of where moral standards and ideals should have their place under contemporary conditions in an increasingly global competitive market economy.

It is obvious that the problems that economic ethics primarily deal with, such as environmental pollution, corruption, unemployment or poverty, cannot be solved without going beyond the economic sector. Therefore, more recent concepts have expanded the term, interpreting economic ethics as economic moral theory, and thereby presupposing a methodical understanding of economics as the general (rational choice) analysis of social interactions and institutions.

The basic problem of economic ethics is that morally motivated conces-

sions and benefits from a minority – be they individuals or →enterprises – can seriously prejudice their competitive market positions, even to the point where the actors concerned are forced out of the market and profits dwindle for as long as the increased costs are not offset by benefits which redress the balance. Under competitive conditions, it therefore frequently seems as though morals and self-interest are mutually exclusive.

Seen in this light, it seems justified to postulate that untamed self-interest should be placed under moral restraint. This line of argument basically means that diagnosis and treatment are both focused on the goodwill of the economic actors: the cause of this predicament is seen to be moral decay, egoism and greed, while the suggested solution is a change of heart and a moral about-turn. The key problem here – and the one which seemingly requires correction – relates to human preferences.

An alternative possible approach would be to direct one's attention not so much to the goodwill, but more to the ability of the actors. The issue would then no longer be the actors' preferences but the restrictions to their acting, i.e. competitive incentives which prevent moral behaviour despite one's better knowledge.

This alternative view of the problem goes back a long way. Reference can be made to Adam Smith, who was a moral philosopher and also the founder of economics as a scientific discipline. His most significant insight concerns the uncoupling of the motivation for our actions from their results under competitive conditions. This has been classically formulated as follows: 'It is not the

goodwill of the butcher, the brewer or the baker which provides us with the food we need, but the fact that they look after their own interests.' In other words: the prosperity of all does not depend on the goodwill of individuals.

From this perspective, the motivation for a specific action – i.e. the degree of the actors' self-interest – is less significant than the social compatibility of the practical expression of this self-interest or, in other words, to what extent it benefits society. If a distinction is made between the institutional framework within which our actions take place and the actions themselves – or, in sportsman's language, the rules of the game and the actual moves – this becomes instantly plausible.

In an economy where the actors make profit the aim of their competitive moves, it depends on the rules whether the pursuit of self-interest is to the detriment of others or to their advantage. The fundamental thesis of economic ethics is, therefore: under today's competitive conditions, the institutional framework has been accorded the position of moral principles.

The pronounced emphasis on rules which apply in equal measure to all competitors is due to the fact that, from the point of view of competition, the consequences of moral concessions must be at least neutral, i.e. they must not create a competitive disadvantage. Only in this way can the moral behaviour of a few be protected from exploitation by competitors. These rules or institutions – which are indispensable if everybody is to be given the chance to benefit from the advantages of competition – include, for example, the right to private property, the guar-

antee of the right to conclude contracts, institutions which assist in the implementation of contracts, laws against restrictive trade, regulations for liabilities, etc. Since morally undesirable situations are not blamed on moral defects of the participants but on functional deficits of the system, necessary changes have to start with a reform of the system, its incentives and their effects. Seen in this light, economic ethics can also be defined as institutional ethics or as motivational ethics.

This concept of economic ethics takes into account the changes which have taken place in the course of the evolutionary process and which comprise the functional differentiation of society into social subsystems. What used to be 'housekeeping' turned into a modern national economy and today even into a world economy. It is characterised by a high degree of division of labour, by anonymous commercial transactions, by lengthy production processes under the participation of a large number of actors, increasing interdependence and high complexity. Therefore, the success of a modern economy does not depend on any individual, any single enterprise or any country in isolation, which means that no one (in particular) can be (made) responsible for it.

The resulting major socio-economic problem of today is the question of how actions can be socially controlled. In everyday life, and applied to small, manageable groups, informal control through praise and criticism is possible and often also sufficient to give moral standards validity.

In large anonymous groups, such as today's global society, it has become

almost impossible and/or very expensive to monitor the behaviour of single individuals. This is why the method of control – which is basically indispensable – has to be modified: in principle, control in a modern society has to take the form of self-control that does not run counter to the personal interests which, through institutionalised incentives, have been made socially compatible.

This transformation of social control has great potential for individual autonomy and emancipation, but also for social productivity and civilisation.

It follows from these considerations that economic ethics also give an indication to what extent alternative regulatory rules might be suitable in the setting of moral standards and ideals under competitive conditions. In this regard, voluntary individual and collective commitments have a special place because they produce the sorts of reliable expectations of mutual behaviour that are needed in a productive cooperation. Such rules gain universal validity only if the individual can be (sufficiently) sure that the others will equally observe these rules. Yet this can be expected only if, when everybody obeys the rules, the benefit for each individual is greater than a breach (violation of the rules), and if as a result everybody agrees to the enforcement of the rules: rules either have to be, or they have to be made, self-enforcing.

Due to the increasing complexity of modern societies, and particularly in the case of transnational problems, the process of the establishment of rules can no longer be left to the individual countries alone. However, political structures that make the participation of non-governmental agencies possible

are currently only at a formative stage. But enterprises such as ‘corporate citizens’, just like citizens’ self-help organisations, are increasingly able to influence the basic regulatory conditions of institutions, both at national and international levels. This means that alternative models of economic ethics will have to prove that they can make a meaningful contribution by initiating constructive dialogue as well as processes of learning between the actors. At the end of the day, even at the global level we have to make a joint decision on the rules according to which we want to play.

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### **Economic orders: Theory and implementation**

The terms, types and functions of economic orders are most easily understood as analogous to a game. All games,

such as the common ball or card games, are based on rules which have a crucial effect on the game itself and indirectly on the result of the game. In the economy, the set of game rules finds its counterpart in the order. Accordingly, the economic order covers the whole of the officially determined rules as well as those which have been spontaneously agreed to by the market participants.

The officially determined rules consist mainly of regulations from public or private law that are relevant to the economy. Examples are the fundamental constitutional laws such as administrative, financial and tax laws, as well as social law with its different subdivisions. In the case of private law (i.e. property, contract, business, labour, patent or copyright law), the economic aspect is even more pronounced.

Finally, the officially determined rules also include the binding agreements and statutes that associations and private organisations adopt. These binding rules, in their entirety, constitute the economic constitution as the underlying foundation of the economic order. The economic constitution is an illustration of the interdependence of the economic order with the political and legal orders.

Besides that, economic behaviour, and consequently economic processes, are also determined by moral and ethical rules (usually unwritten), which have developed over time. In modern terminology, these rules are also called informal institutions. They illustrate the interdependence between the economic order and the respective culture. Although not usually recognised, each economic order, therefore, is also culture specific.

Beyond that, there is system-specific interdependence between the different sub-orders, i.e. between the coordinating, property, business, financial and social orders. These mutual dependencies can be understood only with the necessary knowledge of economic orders and how they work. Economic management was, and is always, in need of and dependent on an order (set of rules and institutions).

Of course, there are different ways of shaping an economic order, which raises the issue of their diverse forms. In this respect, it is important to consider the basic problem of economic management whereby the scarcity of goods is ever present.

One of the basic economic principles is that division of labour and specialisation are indispensable for economic growth. But as the division and specialisation of work becomes ever more sophisticated, economic processes are becoming more confusing and more intertwined. It also becomes more difficult to calculate, control and distribute goods – bearing in mind scarcity and need.

So far, economists know only two ways of tackling the problem of economic control and allocation: the →*market economy* and a centrally planned economy (→*socialism/planned economy*).

In a market economy, the economic processes are independently planned by individuals or economic units, while being coordinated via markets and prices. The market economy therefore represents a system of decentralised planning and coordination of the economic processes where the degree of scarcity of goods is expressed in market prices.



In a centrally planned economy, however, the economic processes are planned by one central government authority and coordinated through a national plan, whereby the degree of scarcity is determined by means of a centrally imposed accounting system.

The socialist economies of the recent past are clear proof that a centrally planned economy is always coupled with a state-planned economy. Therefore, individual economic freedom is not an element of this system. Socialism failed because of economic deficits and the lack of freedom in the order, while the market economy has proved its superiority in the economic orders' competition.

At the beginning of the 21st century, focus is on the global competition between different market systems. It is true that all market economies are basically barter economies at a more sophisticated level, but it is also true that there are different concepts which correspond with different actual economic models (*→types of market economy, →systems competition*). This is due to the fact that basic socio-political objectives such as individual liberty and *→social justice* are not always accorded the same value, and this is in turn connected to the institutional order policy question of what the relationship should be between private responsibility and government intervention.

On the one side is the liberal concept, which postulates the values of individual liberty and direct responsibility, private property, free enterprise and *→competition*, together with legal protection, performance and a minimal welfare state. The other side is represented by the concept of the welfare

state, which accepts private property and a market economy, but at the same time also demands comprehensive government responsibilities regarding the regulation and correction of the market process in favour of social justice and security.

The concept of the *→social market economy* lies between these positions, which is why some of its intellectual fathers started to refer to it as the *→third way*. The aim of the social market economy is an appropriate synthesis between the liberty of the market and *→social balancing* based on government interventions. This means that a balance must be found between a liberal and a productive – as well as a socially fair – economic order.

The market and private initiative are seen as indispensable guarantors for economic prosperity and the individual right to liberty.

Decentralised planning with private accountability and a market-related balance between supply and demand, protect the freedom to consume, free competition and the freedom of occupation, trade, property, contract and association.

In a market economy, competition is seen as the most effective means of keeping economic power in check. This is why the governmental competition policy is given priority within the institutional order policy instruments. The desired social balancing is aimed at the *→labour market order* and the *→social system*, as well as using a number of socio-political measures. The social market economy generates a positive result in Germany while its adjustment to the ongoing challenges remains a constant task.

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*Helmut Leipold*

### Education and research policy

At the beginning of the 21st century, education and research policy holds a key position within economic policy. This is more than ever because the economic survival and success of the individual, and of the economy as a whole, depend on education and research. The knowledge and qualifications (skills) acquired today may become obsolete in the job market in the near future. This applies to skilled workers as well as to engineers and all college graduates.

While in the past a solid training tended to be sufficient for the entire duration of a person's active (working) life, this ceased to be the case a number of years ago because of the rapid technical progress and the structural changes of the economy. Today, the efficiency of education and science matters more than the degree of knowledge and education both the individual and the society as a whole can muster. The main task of the education system and its elements (schools, universities and other tertiary institutions, and enterprises offering basic and further training) is to communicate the values, attitudes, knowledge, skills and competencies which society needs for its communal existence, and which the economy and administration need, as well as to investigate the talents and inclinations of the

pupils and students, and to mould, educate and train the latter in such a way that they are able to use their natural talents to their best advantage, both for themselves and for society as a whole. The educational and scientific institutions are supposed to fulfil this task as economically as possible, i.e. by allocating a minimum of resources (function of allocation).

If an education and science system are to accomplish this, it must be equipped and organised accordingly. In contrast to the national administration, which is intent on implementing laws fairly and treating the individual citizens as equals before the law, here it is essential to recognise and take into account people's different talents. On the other hand, the various requirements of the economy, the state and society have to be correctly assessed and converted into educational goals and contents (curricula) that will shape people according to their needs.

Since the acquisition of information about the gifts of individual people and the future requirements of the economy and society is not easy, and since the newly acquired information is inevitably uncertain, what schools and faculties (the education departments of universities) have to accomplish is a genuinely entrepreneurial task: namely, having to act at the risk of making the wrong decision. This task differs only in terms of content from what the commercial →*entrepreneur* has to do in the market at his/her own risk, and which the school and faculty has so far been able to transfer to the pupils and/or students.

From an organisational perspective, it is obvious that a school or faculty

belonging to an administration cannot succeed, it has been designed to carry out orders from above uniformly and equally. The educational policy of the Federal Republic of Germany takes this into consideration, but at times interprets it in a manner that is outdated.

Each individual is guaranteed the inviolability of person, free development of the personality, free choice of school and free choice of place of training (in the case of minors, indirectly through their parental authority). Furthermore, German education policy guarantees private school liberty, thus the right to establish private schools, and it grants university professors the liberty to conduct research and to teach. Teachers and schools have liberty and thus decision-making power only in the context of legally prescribed curricula and other standards. However, for the past several years they have had more educational liberty and self-sufficiency

(school autonomy) granted to them. It has been recognised that schools have to take more responsibility for the task ascribed to them and, accordingly, also to act more independently.

The crucial point, however, is that those schools that are funded to a large extent by the cities and municipalities and/or municipality federations, are economically not independent but part of the municipal budget. This affects the school buildings, equipment, learning materials and non-educational personnel (caretakers, secretaries). The teachers are government employees. For the universities and other tertiary institutions, the situation is similar: as government institutions, they fall under the state budget.

The consequence is that schools and universities do not have to take any financial risks, and they are not economically liable for their educational, technical and scientific achievements.

#### Germany's education system – key data

Number of pupils (2005/2006)	9,505,241
Number of teachers (2005)	667,711
Number of apprentices (2005)	1,553,437
Number of students (2006/2007)	1,974,932
Approximate expenditures per pupil (2004)	<i>in €</i>
– at primary school	4,000
– at senior school	5,400
– at secondary school	4,400
– at grammar school	5,400
– at vocational school	3,300
Average annual total expenditure per apprentice (2000)	
– average gross expenditures	16,435
– average net expenditures	8,705
Approximate annual expenditure per student (2000)	
– at technical college	6,000
– at university	6,300
Expenditure for Education and Science (2005)	195,2 billion (8.7% of GNP)

Source: Federal Statistical Office, Federal Institute for Vocational Education and Training

In recent years, the state has given schools, and above all universities, certain economic decision-making powers through less detailed directives on where funds are to be spent (increased budgetary flexibility, unspecified allocations), but they do not carry a crucial financial risk.

Finally, teachers and professors are civil servants and have so far hardly been paid a performance-related salary for their educational and training activities. It must be added that in Germany, the state considers itself as the economic producer of education and science and behaves accordingly.

The consequence is that schools and universities are subjected to a large number of rules and regulations, and they are more inclined to follow government directives than to act in the interest of the educational, training and further education needs of their pupils and students. This means that schools and universities produce graduates, but without either being truly interested in their vocational progress or drawing conclusions from it for their own work, in the way profit-orientated enterprises with a presence in the market do as a matter of course and with sophisticated methods.

Discussions on potential reforms are therefore now under way, focused on the question of whether or not the state ought to accord universities and schools more autonomy, while limiting its own influence to the basic conditions (minimum standards, market and achievement transparency, compulsory schooling), which form the background for their →*competition* for pupils and students. Under these conditions, public schools and universities would be on

an equal footing with private (nationally recognised) educational institutions, and the state would no longer be directing its attention to the production of education – seeing itself as a producer – but rather protecting and promoting the educational interests of its citizens. Conflicts arising from the state's responsibility for what happens at schools and universities and its parallel supervisory role (supervision of schools and universities) would thereby be avoided. The state would then be able to focus its attention on the education of its citizens, no matter where they receive schooling and other tuition, training and further education, whether it is in their own federal state or another, or whether at home or abroad. The state would want to promote the best schools, universities and other academic institutions in its own territory.

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*Ulrich van Lith*

### Education funding

Education (school and university education, vocational training and further education) is a solid investment in one's own abilities and talents, as well as an investment in national wealth. The latter consists of human capital (human capital reserves) and the real wealth of a country.

The cost of this investment – in the form of 'learning costs' (personal commitment while forgoing other activities

such as recreation or volunteering, costs of material such as school books, personal computer, etc.) – has to be covered by the pupils, students, trainees and individuals in further education themselves. For the supplier of education (school, tertiary institution, enterprise), they take the form of ‘tuition costs’. Unlike the costs of this investment, the proceeds usually follow only years after the school, the course of study or the professional training has been completed. Only then will the individual and the economy as a whole reap the rewards from the newly acquired knowledge and skills (higher financial income, non-material advantages such as social status, etc.) which, without the investment in education and/or training, would not have been obtained.

An investment is profitable when the total rewards exceed the total costs, in this case the learning and tuition costs. If the tuition costs are carried by the state, personal education becomes profitable as soon as the personal rewards exceed the learning costs.

The gap between the accumulation of the costs (price) for education and its rewards creates the problem of education financing: money has to be spent on teaching (cost of instruction and/or of a place at school, university or at an institution of training or further education) and on learning (living expenses; personal commitment is a subjective sacrifice, but does not entail any expenditure or payment).

The problem of education funding is exacerbated by the fact that the funding of school and university education involves long time periods (e.g. in Germany 10 or 12–13 years of school

and at least 4.5 years of tertiary education). At the same time, the education costs are due for payment, while the future rewards are uncertain.

It also has to be remembered that most pupils are minors who are not legally competent or able to judge the value of education at all. However, as a rule, it should be possible to rely on the parents or guardians – who, in the context of their maintenance obligations have to provide education and training (including school education) to carry its costs and, if necessary, to pay in advance.

The logical consequence of this would be that later, when education investments have started to generate rewards, parents could claim repayment or support during their retirement years – as is the case in numerous cultures where the family and the different generations of a family still exhibit a high degree of cohesion and form an economic unit (e.g. in Asian countries).

In Germany, the state has in the past taken on the costs of school and university education in their totality (zero tariff), but in 2007 some university fees were introduced. This represents considerable savings for the family, and the mandatory long-standing →*pension insurance* supports the view that the education of children has to be regarded as a substantial part of the retirement provision. Beyond that, and independently of the family income, the state contributes to learning costs through maintenance payments in the context of the family burden compensation (e.g. continued payment of child benefits after the age of 18 and up to the age of 26, while children in training) and the Federal Law on Education and Training Promotion.

The funding of educational investments (investments in human capital) becomes a problem and requires the state to take on a subsidiary function for individuals or their families who do not have the means. Contrary to investments in capital equipment, which enable the investor to borrow the necessary funds on the capital market, this is not possible with investments in human capital. This is because the credit-giver requires collateral in order to reduce the risk of non-repayment. If real wealth is accumulated, this could be assigned as security. In the case of human capital, however, that is not possible, since fundamental liberties (inviolability of the person, inalienability, prohibition of hard labour) make it impossible to seize human capital.

Therefore the credit-giver can resort to seizing the monetary proceeds

(financial income) only if an income results after the completion of the training. But here, too, access may be limited insofar as it is non-attachable. Above all, the credit-giver does not know whether years later, for example, after completion of a programme of study, the borrower will be prepared to begin working (starting a family, maternity) or become unemployed or unintentionally avoid repayment (change of address, move abroad, false income data).

For these reasons, banks are only prepared to advance the finance for school attendance or a course of study if they obtain other collateral (material property, parental surety, etc.). It therefore improves efficiency if the state undertakes the pre-financing in all cases in which a pre-financing (loan financing) of profitable educational investments would otherwise not take place.

<b>Private education funding in Germany</b>	
<p><b>Funding for instruction costs</b></p> <p>(The costs of a place at school, university or training college )</p> <ul style="list-style-type: none"> <li>• through prices and fees (beneficiary pays) school and university fees, previously also apprenticeship fees for vocational training (for government institutions: school and university fees )</li> <li>• through voluntary contributions (direct donations or via school or university trusts)</li> <li>• cash donations (indirectly also material donations and voluntary work by parents, pupils, students and others), endowments</li> <li>• through additional contributions                             <ul style="list-style-type: none"> <li>– sponsoring, advertising, selling promotional items such as T-shirts etc., letting premises, the sale of services such as computer training, etc.</li> </ul> </li> </ul>	<p><b>Funding for learning costs</b></p> <p>(Transport costs, learning materials such as school books, software, notebooks, living expenses)</p> <ul style="list-style-type: none"> <li>• through own resources (savings), parental means</li> <li>• through bursaries, etc., private contributions from third parties</li> <li>• through gainful employment, additional occupations (self-employed or employed)</li> </ul>

If this is not done, a loss for the individual as well as for the society as a whole will result. For practical reasons, the state usually covers tuition costs in total for the duration of compulsory schooling, and in Germany even beyond that, i.e. senior high school and higher education. In 2007 university fees were introduced. In addition, child benefits, the Federal Law on Education and Training Promotion and tax advantages represent government contributions to the cost of living.

While these financing difficulties apply to school and university education and are a challenge for the government, in the vocational part of education (training and further education) the situation is different: on the one hand, in vocational training the gap between costs and proceeds is significantly narrower. Besides, in many professions the yields (productive contributions by the trainees to the operational result of the enterprise) already cover the training costs during the period of training.

On the other hand, the training companies and  $\rightarrow$ *enterprises*, unlike banks and other financial institutions, are prepared to pre-finance the costs of the training. They do this because they have selected the trainees themselves, knowing which qualifications the company will require in the future, and in the sure knowledge that they will be employing some of their own trainees in a regular employer–employee relationship after the completion of their training. To provisionally meet training costs by pre-financing them is more convenient for them than having to recruit new skilled labour in the market place at higher wages. However, this method of financing vocational training

has its limits. It is successful only when companies and enterprises are ready to offer training places. In the past, trainees had to pay an apprenticeship premium in order to make the companies more eager to offer training. Today, once again, the state takes over by giving the companies handouts or tax incentives in these cases, which is basically the same as partial pre-financing.

If we differentiate education funding according to the criterion of who receives direct payments, then in principle two methods of education funding can be distinguished: ‘supply funding’ and ‘demand funding’.

In supply funding, places at schools, tertiary institutions or training institutions are directly funded by government. The respective institution receives the funds according to certain criteria (ratio of pupils, students, graduates, capacity regulation). The supply funding has to clearly distinguish who the carriers are of the schools, universities and training facilities and who is responsible for the education and/or the training (education production). This does not always have to be the state, but it can be private schools or independent public schools. In demand funding, the pupil (parents) and/or the student receives the financial means for the financing of a place at a school, university, institution of training or further education of choice. This can take the form of tied assignments, education coupons or loans with different payback conditions (*see box, next page*).

This sort of education funding makes clear that national education production and national education funding are two different issues. Logically, the latter would also open up

### Government education funding in Germany

#### ***Supply-orientated funding***

(funds go directly to the school or the university)

- Institutional funding, structured budget (detailed itemised instructions for means allocation, not directly related to the service rendered)

Deficit financing

e.g. for officially recognised private schools

- flexible budget (limited transferability of budget positions in terms of time and material)
- total budget: according to key data and discretionary (performance-related)
- according to key data, e.g. number of pupils, school-leavers; per capita allocations, flat-rate e.g. as a flat-rate allocation per pupil at private schools in certain federal states (Baden-Württemberg, Lower Saxony and others)

#### ***Demand-orientated funding***

for instruction and learning costs, whether intended for a specific purpose or not

- independent of the family income
  - fixed amount per capita/ year and/or term covering all or part of the costs
  - per unit (e.g. teaching unit, lecture), as a subsidy covering all or part of the costs of the unit
- income-linked, per capita and graded as educational subsidy, in voucher form or in the form of tax concessions deductible in retrospect from the payable income tax in absolute amounts up to a maximum amount (civil tax, negative income tax, when the deductible amount exceeds the payable income tax: net payment)
- tax-deductible from the taxable income up to a certain amount, e.g. as contingent expenses
- in the form of a loan with fixed or income-linked repayments with or without subsidised interest, government bond with special provision for repayment dispensation such as pregnancy, unemployment, disability, death, etc.
- as a combination of grant and loan: e.g. the Federal Law on Education and Training Promotion and the master craftsmen training scheme
- other concessions (subsidies) for health and pension insurance (credited assimilated periods), rental, subsidised entrance fees to public amenities such as museums, theatres, etc.



the possibility of funding schooling or a study course abroad. One prerequisite will generally be that the educational institutions should either be government schools or universities; or that they should otherwise be officially accredited (approved schools, chartered universities).

For the development of a European education market, this form of funding carries special importance. It demonstrates that the state has to support its citizens with the funding of their education and training, and that citizens have to be allowed to decide freely, within reason, at which school or university they would like to acquire their knowledge – state or privately run, at home or abroad.

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## Employment

The problem of →*unemployment* has immediate and lasting consequences (reduced standard of living, psychological problems). Economic policy therefore gives priority to job creation and the fight against unemployment.

Economists are concerned with unemployment in order to determine its causes and to give politicians recommendations on economic policy. In principle, the level of employment results from the interaction between the supply of and the demand for labour. The excess supply on the labour market is usually calculated only against the level of unemployment, although an additional number of potential suppliers of labour may have ‘quietly’ withdrawn without being entered into the unemployment register.

### *Components of unemployment*

Despite the multiple forms of unemployment, it is useful to divide the number of unemployed into a frictional-structural component and into a surplus of supply.

#### *Frictional-structural component*

Frictional and/or structural unemployment is attributed to placement obstacles between →*supply and demand* on the job market. This is because both labour supply and labour demand are subject to different requirements regarding regional availability, qualifications, etc. This causes difficulties in matching job-seekers to job vacancies – a situation reflected in the coexistence of unemployed persons and vacancies.

In any market economy, a certain amount of unemployment is inevitable in spite of the full range of economic policy measures. Above all, this frictional and/or structural unemployment is also indicative of the continuing structural transformation that can be expected in economically normal times, and which continually causes long-standing jobs to be disposed of and new

ones to be created. The fact that this transformation cannot occur completely without friction (thus without difficulties and/or temporary delay), leads to the permanent phenomenon of an unemployment ratio.

This natural unemployment ratio (natural rate of unemployment: NRU) describes the average level of unemployment around which the statistically measured unemployment varies in terms of duration. It is actually anything but natural and is determined by the ratio of those employer–employee relationships which have been dissolved and those which have been newly formed (more exactly: probabilities of dismissal and of reinstatement). These two regulating factors are especially affected by welfare transfers, minimum wage legislation, protection against unfair dismissal regulations as well as protection against structural change, created as a social cushioning against unemployment.

A high and permanently granted wage compensation (unemployment pay), for example, reduces the labour supply since it lowers the incentive for workers to take up new positions. Those who are employed approve of this, since their competition by unemployed persons is reduced.

A new explanation by the NRU offers the ‘hysteresis theory’: generally, the term hysteresis describes the long-term influence of past historical or economic events on the natural ratio. For the NRU, this particularly means that the NRU will rise during the current period if the actual unemployment ratio of the preceding period exceeded the NRU of the preliminary period (time-path dependence).

There are two ways to attempt an explanation: The ‘long-term unemployment theory’ states that while they are jobless, unemployed individuals lose qualifications and that, in this way, the number of long-term unemployed rises.

The ‘insider outsider theory’ stresses the power of those in jobs, who can prevent necessary wage reductions and thus keep outsiders (unemployed persons) away from the labour process.

#### *Surplus supply*

Surplus supply – the second component of unemployment – is the difference between the total labour supply and the number of workers required by →enterprises. For the analysis of the surplus supply, two models are available: while the neo-classical school always attributes a surplus supply in the job market to inflated wages in real terms, and the responsibility for the level of employment to the parties to a collective agreement, the Keynesian opposite standpoint claims that imbalances in the labour market reflect a true lack of real demand for the products of the economy.

In an unemployment situation, therefore, a wage reduction in real terms and/or the stimulation of the demand for goods appear indicated if unemployment is supposed to decrease. The crucial variables combined – especially price level, consumer demand for goods, employment and wages in real terms – represent a ‘simultaneous system connection’, which cannot be so easily manipulated by the economic policy-makers.

It has been shown that the relationship of consumer demand for goods

and nominal wages is relevant to the determination of the employment level. Monetary, fiscal and tariff policies can have an impact on this relationship.

### ***Beveridge curve***

The Beveridge curve was named after Lord Beveridge, scientist and English employment minister after the Second World War. It makes it possible to divide the unemployment ratio into the components specified above, and describes the negative convex connection between the unemployment ratio and the ratio of vacancies. An increase of open places thus leads to a lowering of the unemployment ratio and vice versa.

The extent of the frictional-structural component of unemployment can be expressed through the spatial layout of the Beveridge curve. On the other hand, the supply and demand constellation in the labour market determines where on a given Beveridge curve we are.

### ***Magic square***

Economic policy, besides aiming at a high level of employment, subscribes to three further macroeconomic goals (the Law for Stability and Growth of 8 June 1967). However, since some of these cannot be realised simultaneously ( $\rightarrow$ *conflicting goals in economic policy*), it is called the 'magic square' of economic policy.

### ***Appropriate and ongoing economic growth***

Economic growth is defined as the differential when comparing the current gross domestic product (GDP) to that of the same period of the previous year. The negative relationship between unemployment and GDP which can be observed in reality is called the Okun's

law (unemployment goes down when the economic growth rate rises). However, no quantity or quality of  $\rightarrow$ *growth* leads directly to a lower unemployment rate. The unemployment ratio remains unchanged if the actual growth of GDP corresponds to 'natural' growth of the GDP. This 'normal' growth is based on population increase, the accumulation of capital and technical progress. If, however, actual economic growth exceeds normal growth, then the unemployment ratio goes down. Due to this feature, the natural GDP growth is also called the 'occupation threshold'. In the United States, during the 1960–1998 period, the occupation threshold was about 3%.

### ***Price level stability***

During the 1960s and 1970s, a negative relationship between inflation rate and average unemployment ratio (low unemployment plus higher inflation rate and vice versa) was discussed as the Phillips Curve. It was assumed that economic policy could choose (trade off) between the two goals: an unemployment ratio which is pleasing to the government can be 'bought' by an appropriate inflation rate. This relationship could be observed only in the short term and under certain conditions. In the long term, however, one cannot choose between unemployment and the inflation rate since during the wage-fixing process, the parties to a wage agreement anticipate the government's readiness to produce inflation and their wage demands are based on this anticipation. In the long term, therefore, prices and wages rise at the same rate, and real wages (wages divided by the price level) continue to be the most

important assessment ratio for employment. This also explains the phenomenon of stagflation: despite higher unemployment, price levels continue to rise. Thanks to steady and predictable monetary policy measures by the central bank,  $\rightarrow$ price level stability thus forms the indispensable foundation for an adequate employment increase.

#### *Balance of payments*

Especially in the Federal Republic of Germany, turning points in the economy were repeatedly initiated through changes in the level of the foreign contribution. To that extent, there is no empirically justified contradiction between the goal of a  $\rightarrow$ balance of payments equilibrium and the goal of full employment. However, an increase in exports does not necessarily lead to an improvement of the labour market situation. Rigidities in labour markets, such as high recruitment and dismissal costs or immobility of the workers, may slow down the incentive for additional employment.

The type of exchange rate system that is implemented also plays a role ( $\rightarrow$ currency system and exchange rate regimes). If in the interest of one's major trading partners one opts for the elimination of the risk of monetary fluctuations by fixing the exchange rate irrevocably in, for example, a monetary union, the negative effects of hyper-inflated wage agreements on the labour market can no longer be balanced by a devaluation of the domestic currency. This may mean that the competition between country-specific job regulations rises ( $\rightarrow$ system competition).

Incentives for structural reforms on sclerotic labour markets ('euro-sclero-

sis') have increased. Through these endogenous effects of the monetary union, conflicting aims can be avoided. Flexible exchange rates mean that conflicts between domestic economic stability goals and the balance of payments equilibrium are largely avoided or solved through exchange rate adjustments. A condition for this is, however, that the exchange rate adjusts in a systematic and foreseeable way to changes of fundamental economic data (prices,  $\rightarrow$ income).

Conflicts between the goal of a high level of employment and the three other goals of the 'magic square' are generally not an issue when prices, rates of pay and interest rates are allowed to find their levels as freely as possible, when  $\rightarrow$ competition is reinforced and when a steady monetary policy is practiced. To get rid of unemployment, the supporters of the hysteresis theory therefore suggest complementing expansive demand policies (lower interest rates, expansive fiscal policy) with supply measures that are aimed at greater flexibility (incentives for investment, wage restraint) (a two-handed approach).

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## Employment policy

### *Areas of employment policy*

In the economic policy debate, employment policy is frequently equated with concepts which concern only their subdivisions (e.g. labour market policy). The term 'employment policy' refers to all economic policy activities that deal with labour as a factor of production and have an impact on the employment situation. In this regard, it is basically those individuals in gainful and dependant employment who are at stake.

'Labour market policy', however, is a name for measures that try to affect supply and demand on the job market and the way they relate directly. This means that employment policy covers a larger field than labour policy only. Beyond that, employment policy entails employment-promoting measures which, strictly speaking, belong to the sectors of economic policy, growth and structural policy.

The largest part of wage policy as well as →*Concerted Action/Alliance for Employment* can also be subsumed under employment policy. Above and beyond the (sub-)divisions mentioned here, employment policy as a generic term is closely related to other political fields, e.g. to →*social policy*. The quantitative goal of employment policy lies in reaching a high level of employment.

### *Strategies of employment policy*

Strategies and instruments of employment policy are supposed to redress the imbalance between labour supply and labour demand and thus to reduce →*unemployment*. In principle there are two different ways of tackling this: either from the supply side or from the

demand side of the labour market. In practice, the emphasis of employment policy strategies lies in the measures geared at the demand side.

#### *Strategies geared at the supply side of the labour market*

Decreased labour volume is brought about by the reduction of the number of potential wage-earners (demographic component, decreasing desire to be gainfully employed, migration trends) or by a reduction of working hours (→*collective agreements*, e.g. the standardisation of a shorter work week or longer vacations or individual regulations).

#### *Strategies geared at the demand side of the labour market*

Here, the target is an increased demand for labour since the job market is derived from the goods market and the demand for work depends on planned goods production. Strategies having an impact on employment must therefore be geared at the production volume:

- Business cycle policy actions (increasing total demand through expansive monetary and fiscal policy →*business cycle policy*).
- Structural policy measures (promotion of structural change →*structural policy*).
- Growth policy measures (in times of continually poor growth). How many additional jobs this yields, though, crucially depends on the development of economic growth and overall economic productivity, i.e. starting from which growth rate total employment figures rise ('employ-

ment', e.g. West Germany 1987-1993 0.7%).

### **Wage policy and labour market**

On the German labour market, wage-fixing is not consequent upon the free play of  $\rightarrow$ supply and demand. Rather, it is the result of nominal wage negotiations between trade unions and employers' associations in the context of bargaining autonomy (Article 9(3) of the Basic Law).

Through the labour market regulations, the parties to a collective agreement have been given considerable responsibility in the field of employment policy (employment policy assignment).

Therefore, tariff policy must contribute to the preservation of existing and the creation of new jobs and, by leaving sufficient scope for regional and industry-related differences, as well as for differences of qualification and the special situation of individual enterpris-

es ( $\rightarrow$ collective agreements). The attempt to maximise the wage ratio (proportion of earnings of the national revenue derived from employment-based jobs) through higher wage demands is useless in that it simply substitutes the labour factor with the capital factor (rationalisation).

### *Wage levels and employment*

In the current debate on the high unemployment ratio and its causes, the argument that wage levels in real terms are too high, as well as the consequent recommendation to slow down wage level development in order to increase employment, plays an important role.

The demand for work decreases proportionally to the increase of production costs. Not only is the increasingly expensive factor 'labour' replaced by the relatively less expensive factor 'capital', shrinking profits lead to fewer investments. Thus the neo-classical labour theory sees the cause for unem-

**Fluctuations in the German job market, 1996 and 2005 (in 1,000)**

	<b>West Germany</b>		<b>East Germany</b>	
	<b>1996</b>	<b>2005</b>	<b>1996</b>	<b>2005</b>
Outgoing (leaving) unemployed	4,684	4,609	2,101	2,256
Incoming (entering) unemployed	4,967	4,823	2,175	2,163
<i>Of these:</i>				
– currently employed (not gainful)	2,511	2,082	1,287	1,035
– apprenticeship	129	238	50	105
– previously unemployed	2,388	2,503	838	1,023
Incoming job vacancies	2,388	2,021	890	710
Successful job procurement	2,553	2,601	811	917
		(year 2000)		(year 2000)
Average duration of unemployment (in weeks)	29.3	36.3	27.9	46.3

Source: Federal Employment Agency: Labour Market 2005

ployment primarily in the wage monopoly of the workers' and the employers' associations. The tariff wages negotiated by them usually have the effect of a minimum price (minimum wage), which is fixed above equilibrium level ( $\rightarrow$ labour market order).

#### *Pay structure and employment*

Additionally, a faulty pay 'structure' has been made jointly responsible for the employment problems. In terms of industry, qualifications and region, wages do not correspond to the specific conditions of supply and demand (mismatch). This leads to misguided policies regarding production and employment structures, and to a decrease of the potential employment volume.

Yet the Keynesian opponents of this position interpret wages as income creating demand, and conclude that if because of rising wages demand grows, production and employment are expanded (purchasing power argument)  $\rightarrow$ Keynesianism.

#### *Wage fixing in the context of bargaining autonomy*

Four concepts of wage policy can be distinguished:

- productivity-based wage policy (nominal wage increase = rate of growth of the overall economic productivity)
- cost level neutral wage policy (wage increase = growth rate of productivity +/- change of non-wage related costs)
- cost level neutral wage policy (as above + increase for prospective unavoidable price level increase)

- redistributive wage policy (+ redistribution surcharge in accordance with purchasing power argument)

#### **Alliance for Employment**

At a summit on 7 December 1998, the federal government as well as representatives of the trade associations and the trade unions agreed to work together in an alliance towards a reduction of unemployment and, in addition, to make the economy stronger and more competitive in the long term.

It was felt that for a positive development in the labour and professional training markets, a 'durable cooperation and understanding between the state, the trade unions and the economy' is required.

The parties involved in the Alliance for Employment, Education and Competitive Ability are, among other things, aiming at a further sustainable reduction of the legal marginal wage costs, as well as a structural reform of the social security system.

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#### **Enterprise, plant**

The main competence of an enterprise or business is its ability to establish products and services through  $\rightarrow$ competition in the national and international markets. To succeed in this requires competitive advantages, which may be located in such different areas as:

- the product, manufacturing technique, production costs as well as service quality;
- the sales network, brand name and product image; and
- the ability to stay at the cutting edge of technology through high quality innovations.

While private enterprises usually want to make a profit, with the shareholders bearing the risks and responsibilities of running a business, public enterprises are focused on providing a service at government request (→*public enterprises*). The federal government, federal states or municipalities – and thus at the end of the day the taxpayer – carry the risks and liabilities.

In normal everyday usage, the terms ‘enterprise’ and ‘plant’ or ‘factory’ tend to be used as synonyms. From the business management point of view, the term enterprise/business puts more emphasis on the financial and legal entity (external view). The term plant or factory, on the other hand, describes a local or technical and organisational economic unit (internal view).

Since the emergence of the internet economy and the →*new economy*, these old-fashioned definitions have become increasingly fluid: thus today, ‘virtual enterprises’ are networks of independent companies that come together only for a short time – for example, to combine core competences or for the production of certain products or services.

For higher visibility in the international markets, new organisational forms such as joint ventures (several enterprises start a joint enterprise) or

strategic alliances are developing. Here, it is basically no longer possible to assume an economic or legal entity. Markets are becoming more international (→*globalisation*), and enterprises have to follow this trend in order to remain competitive.

In their desire to service the international markets, enterprises are concentrating on location factors. Despite numerous location advantages in Germany, such as the dual education system and the good infrastructure, international investors react with caution regarding over-regulation especially of the →*labour market*, as well as the singularly high level of →*co-determination*. This explains the small percentage of foreign direct investment in Germany compared with other OECD countries.

In recent years, the topic of corporate governance has gained in significance. Legally and formally, the control of a company and its executive committees lies with the supervisory board, the actual controlling body of a company. The supervisory board is usually elected by the shareholders at annual general meetings.

As the international financial markets are opening up, however, the supervision of companies is largely performed through the submission of financial statements and transparent reporting in the capital markets.

Regarding the possible legal forms, a distinction has to be made particularly between sole traders, non-incorporated firms and corporations: according to sales tax statistics, most of the businesses in Germany are run as sole traders (more than 2 million in 2001). The special features of the sole trader are the



exclusive decision-making powers and the sole right of disposal, while liability for the commitments of the company extends to all personal assets (business and private assets). But →*property* also holds a social obligation. Business decisions are not arbitrary. The practical side of running a company demands the inclusion of the staff on issues that concern the business.

Non-incorporated firms require at least two associates. Here, too, capital and management are usually located in the same persons. With the exception of the limited partners in a limited partnership (their liability is limited to the level of the deposit) partners are also liable to the extent of their total assets. The most common legal forms are the general partnership (more than a quarter of a million enterprises in 2001) and the limited partnership (more than 100,000 enterprises in 2001).

In corporations, liability is limited to the capital of the company as a legal entity. Investors and management are frequently separate. The most common corporate legal form is the limited liability company or Ltd (nearly half a million enterprises in 2001). Only 6,856 companies (in 2001) were registered as legal corporations (public limited company).

It is certainly striking that in Germany, medium-sized companies predominate: 89.9% of businesses have a staff complement of less than 20 and 99.8% have fewer than 500 employees. In terms of staff numbers, this means that only 0.2% of businesses can be classified as large enterprises. The result is similar – depending upon the industry – in the ranking order based on sales volumes.

Medium-sized businesses employ more than two-thirds of the entire workforce in the private sector in Germany and are responsible for 48.8% of the gross annual product. But the large-scale enterprises with more than 500 employees, which make up less than a quarter of 1%, are responsible for more than 50% of the entire sales volume.

The 25 largest enterprises in Germany were already large by 1960. In the United States, however, one-third of the top 25 companies are newcomers which were started only in recent years – especially in the field of information technology.

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### Entrepreneur, manager

Originally, the term entrepreneur used to refer mainly to the owner or proprietor of a business, running an →*enterprise* independently and at his or her own risk, by being liable with the capital of the business or with his or her total personal assets. The source of capital and the entrepreneur were one and the same. The first listed companies during the 19th century brought with them the new phenomenon of the

employee-entrepreneur or manager. He also has far-reaching entrepreneurial decision-making powers, but he is acting on behalf of and at the risk of others. Through share options (salary payment in the form of an option between money or shares in the business) the manager, too, can become a joint owner or shareholder in the enterprise. Supervision of the company's executive committee is incumbent upon the supervisory board. Changes among the managerial staff are normal.

More than 94% of the 3.1 million enterprises in Germany are owner-managed, while just under 5% are corporations and as such run by managers who are company employees. Entrepreneurs are flexible: they can decide when what is produced, where and how. This makes location factors so important, including legal, tax, financial and social systems, as well as the quality of education, the proximity of universities and the transport and service infrastructure ( $\rightarrow$ system competition).

The greatest challenge for entrepreneurs is their role as innovators who, within the framework of the  $\rightarrow$ market economy, have to use personal initiative to make profits while being prepared to perform, to take risks, and to improve company results.

The practical application of inventions, the continual renewal of products and production processes, as well as the opening up of new markets are all genuine entrepreneurial tasks, and it is in this spirit that the Austrian economist Joseph Alois Schumpeter coined the term 'creative entrepreneur' or 'pioneer entrepreneur'. Drive, creativity and organisational and people skills are all essential core competences in business.

By way of markets and  $\rightarrow$ competition, a dynamic that starts off as commercial self-interest ends with optimum fulfilment of consumer desires (potential sales) and an increase in the general level of prosperity. But economic renewal and structural change do not make the temporary loss of unprofitable jobs a thing of the past. Entrepreneurial  $\rightarrow$ competition and market selection are the best way of returning to full employment and remaining competitive through innovations, regained competitive ability and economic  $\rightarrow$ growth.

The economic and socio-political joint responsibility of the entrepreneur develops in the age of  $\rightarrow$ globalisation and internet economy in a new field of tension. New international production processes and business models, and international competition for the predominantly regionally active suppliers contribute to a drastic aggravation of the international location competition. Accelerated decision-making must be supported by flatter enterprise hierarchies.

The exaggerated focus on shareholder value, to which entrepreneurs and managers have been subjected, is wrong. Lasting entrepreneurial success can be achieved only with the cooperation of the workforce, especially under most difficult competitive conditions. The interests of the business owners and the workers are therefore only seemingly opposed to each other.

Germany needs to adopt a new entrepreneurial mentality: international investigations prove that regions with the highest growth rate of new businesses, for example, the United States, Canada, Spain and Ireland, also have

relatively higher economic and employment growth.

It is true that the number of new businesses which were established in Germany since the end of the 1990s had increased to 761,000 a year. A survey of bank accounts shows, however, that since the beginning of the 1960s the proportion of people who are self-employed has decreased in relation to the total number of people in gainful employment from just under 17% to just more than 10%. These values place Germany far below the European Union average of 15%.

The new reality of company establishments requires a stronger integration of the international capital markets. While the German financial system is frequently based on long-term personal relationships between enterprises and financial establishments that are not very transparent, the Anglo-Saxon system must rather be described as reserved, short-term and largely transparent. The differences between the two cultures are becoming more and more apparent. Against this background it is interesting to observe that in recent years, particularly in the new technologies in the United States, innovation and growth have been far stronger than in the economic systems of Europe, which are less willing to undergo reforms and are held back by rigid social systems and the lack of venture capital.

The readiness to engage in private business activities is crucially to be supported by the removal of government regulations in almost every economic sector, lower taxes and contributions, continued fearless →*privatisation* policies, →*deregulation*, the promotion of

venture capital markets and a competition-orientated transformation of the education system.

Creativity, →*individual responsibility*, being prepared to take risks and leadership skills must become priorities in basic and further training. But it is equally important that within the population there is a growing awareness of the crucial role of the entrepreneur for the efficiency of the entire national economy.

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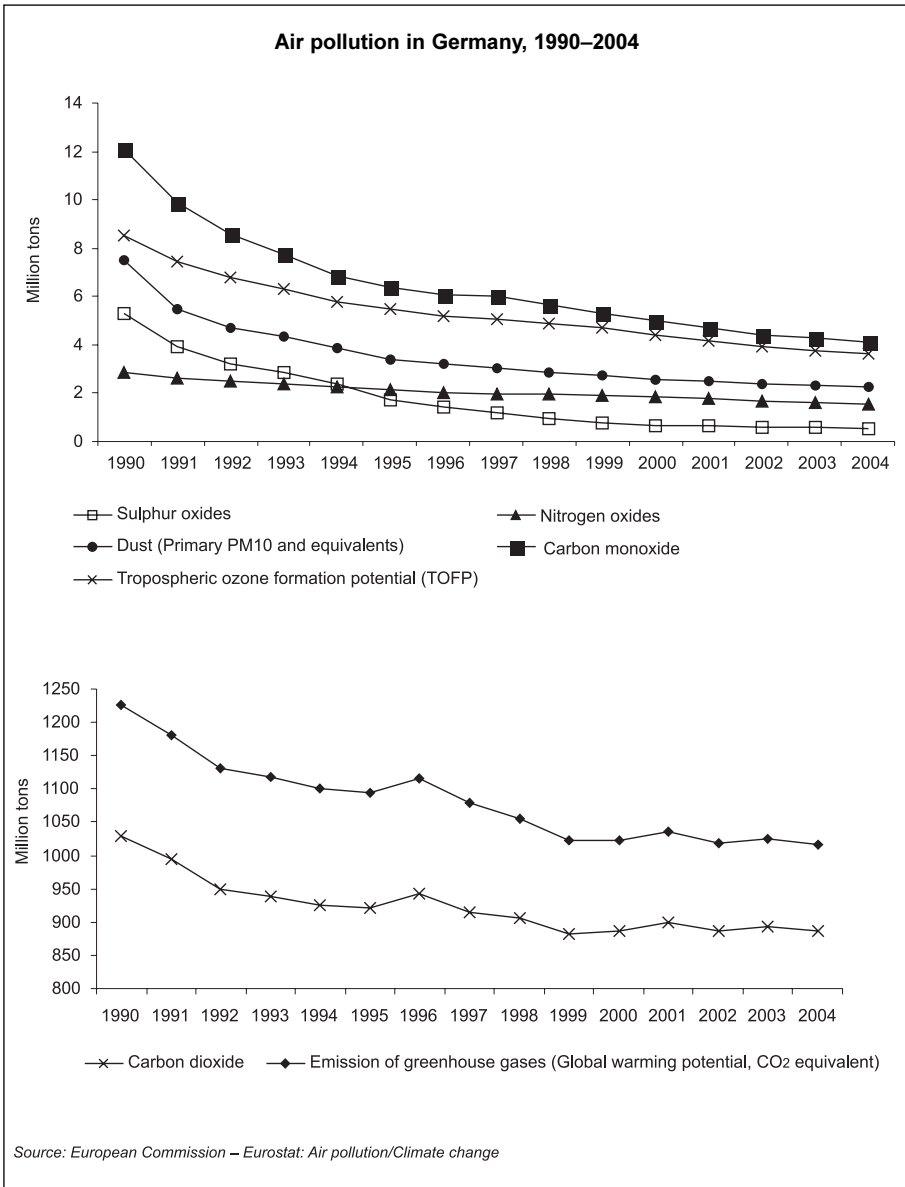
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## Environmental impact

Environmental impact studies distinguish between global and regional environmental problems. The former are on the increase. Here, local activities (the running of factories, the mining of resources or the dumping of materials) have global effects and demand concerted action by as many countries as possible, and possibly by all. Regional environmental problems, however, usually result when local uses of the environment for the purposes of production or consumption have an impact only on the immediate environment.

As far as regional impact phenomena within the borders of a country are concerned, the national environmental policy is faced with a challenge. Globally, it is above all the saturation of the earth's atmosphere with greenhouse gases and the shrinking ozone layer, the quantitative and qualitative

deterioration of the fresh water supply, the decreasing diversity of species (biodiversity), the reduction and qualitative deterioration of the soil (desertification), and the over-use of the world's oceans (through over-fishing and excessive inflow of pollutants), which play an important role.



Carbon dioxide (CO<sub>2</sub>) is the most abundant greenhouse gas. Up to the industrial revolution, the CO<sub>2</sub>-concentration in the terrestrial atmosphere was slightly more than 280 parts per million by volume (ppmv). Since then, this value has been rising continuously. In 1958 it was 315 ppmv, and at present it stands at some 370 ppmv. Extensive investigations by climatologists, particularly by the Intergovernmental Panel on Climate Change, point to the conclusion that this increase, and the associated rise of the earth's average surface temperature of between 0.4°C and 0.8°C, have been primarily caused by humans.

Simulations have shown that if the present trend of fossil fuel use continues (especially of hard and brown coal and mineral oil), by 2100 CO<sub>2</sub>-emissions will have pushed up the atmospheric concentration to over 700 ppmv, making a further increase of the earth's average surface temperature of between 1.4°C and 5.8°C likely. This could have serious implications for the global distribution of the vegetation zones, make turbulent weather conditions more frequent, cause sea levels to rise and be generally harmful for large geographic systems (by causing the gulf stream or North Atlantic currents to change course).

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## Environmental policy: Actors

The relevant authorities (or actors) in environmental policy are mainly the public regional government authorities (→EU, →Federal Republic, federal states, municipalities) which are directly responsible for the adoption and implementation of environmental policy objectives and measures, but also certain groups in the society who exert an indirect influence on environmental policy.

### *Federal Republic of Germany*

Competences in the field of environmental policy are defined in such a way that the Federal Republic is mainly responsible for the adoption of the appropriate laws (the legislative authority of the federal government). As a result, the legal framework that specifies maximum output values of pollutants at the individual source in the form of concentration values has general validity. But the fact that the environment presents different problems and conditions (regarding the difficulties associated with clean-up operations and existing environmental damage), is usually not taken into account.

Administrative issues tend to be the responsibility of the German federal states, from where some of the tasks are again transferred to the district administrations (special administrative units of the states); the states have administrative or implementation authority. This means that environmental policy adheres to competence allocation, as it is customary in Germany on the basis of the Basic Law. However, the delimitation of environmental policy competences within the European Union (EU) has been particularly problematical.

Over the past years, the influence of the EU in environmental policy has been growing all the time. Through guidelines and regulations, the EU tries to become involved in the environmental policies of the different countries. A well-known example is the new general guidelines for water management issued by the EU, which prescribe uniform water management regulations.

But the regulations and guidelines of the EU are frequently in conflict with the subsidiarity principle in Germany, which prescribes that public tasks should be executed at the lowest possible level. Only if that level is not up to the task can it be transferred to the next higher level (→*fiscal federalism*).

If an environmental problem is limited to a regional dimension because, for example, the environmental impact is geographically limited, it should preferably be dealt with at a regional or national level, as opposed to the European level.

### **The actors**

The actors who exert their influence on environmental policy decisions differ depending upon environmental sector and the type of problem encountered. The actors in charge of waste disposal, for example, are not the same as those who are responsible for the classification of a nature conservation area. The general level of problem perception among the public can mean that a specific issue may barely be paid any attention at a specific point in time due to the fact that public awareness is low, while at other times when the public is highly sensitised there will be active involvement. Apart from that, international and global environmental prob-

lems, such as climate protection, have special status where the individual nation states are the actors.

Within national borders it can usually be expected that besides politicians and the public institutions, business representatives on the one hand, and environmental activists on the other, are two important groupings which have a major impact on the determination of environmental policy objectives. Both interest groups have different goals: while the business representatives are keen to set environmental protection standards at the lowest possible level in order to limit their costs and to stay abreast of the international location competition (→*system competition*), the environmental activists want to achieve the most far-reaching protection of the environment they can get.

Important environmental associations in Germany are the German Federation for Environment and Nature Protection, the German Society for Nature Conservation and Greenpeace. In recent years, however, the debate around the definition of environmental goals has become less heated than it used to be. From the point of view of the →*enterprise*, there seems to be a growing understanding that environmental protection is an important image factor, while the environmentalists are increasingly prepared to take economic necessities into account.

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Bernd Hansjürgens

### Environmental policy: Conflicting aims

Like all the other useful profitable activities, environmental protection measures also require expense, i.e. resources have to be spent on them. This creates competition with other potential uses, for resources are always limited. One example of this is a revenue neutral ecological tax reform.

Revenue neutrality means that →enterprises receive a rebate to balance their overall tax bill, for example, through a reduction of the costs of fringe benefits. This does not, however, mean that an ecological tax reform is free – the enterprises concerned put environmental protection measures in place in order to decrease their tax burden, and these measures represent a consumption of resources: they cost money.

An analogous situation can be observed if the public sector implements environmental protection measures, although the same resources could be spent on upgrading the health service or the education system.

But environmental protection measures not only cost money, they also create benefits. Some of these benefits are of a purely financial nature, when for instance building renovation costs are saved, environmental disasters are prevented or diseases due to environmental factors decrease. There are also benefits which are more difficult to measure: e.g. the benefit from the prevention of a disease includes not only the financial savings resulting from hospitalisation becoming unnecessary, but also in the simple fact that healthy people feel better than ill people.

Empirical investigations show that the benefits of environmental protection measures clearly exceed their costs. This applies above all (but not only) to developing countries, where contaminated drinking water and other environmental problems lead to disease and considerable losses of productivity.

At the macroeconomic level, the question arises whether a relatively strict environmental policy, as practised in Germany, may lead to an international competitive disadvantage due to increased production costs. This concern may be justified in specific industries but, overall, it has neither been theoretically nor empirically proven. On the contrary, investigations show that the strict environmental policies in Germany led to a strong position on the world market in the field of environmental protection technology, because German enterprises invested promptly in research and development and have therefore become technology leaders (→globalisation).

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*Eberhard Feess*

### Environmental policy: Instruments

Before becoming involved in environmental policies and objectives, it is important to consider which instruments are likely to be useful. To the question: Why should there be anything to consider?, the answer might

be: 'If people don't want a polluted environment, then pollution must simply be outlawed!'

However, bearing in mind the saying that 'everybody is a polluter', and adopting this rigid attitude would of course mean that mankind, as a whole, would have to be outlawed.

In view of certain disadvantages of this 'solution', a more moderate version of the above postulate might say: 'It must be made illegal to put more than a certain amount of strain on the environment.'

By and large, environmental policies in Germany and elsewhere indeed tend to stick to this simple and seemingly reasonable approach. Industrial installations which have an adverse impact on the environment are subjected to regulations. Thanks to this environmental policy instrument, maximum emission ratios can be specified and the application of certain techniques can be prescribed. In Germany, this is based on the Federal Emission Control Act, which contains the Technical Instructions on Air Quality Control, the Large Combustion Plant Ordinance, the Act on Water Resource Management and many other laws and regulations. The government has the task of making sure that these laws and regulations are observed and that infringements are penalised.

This method does have serious drawbacks, however. When a maximum emission value is stipulated, nobody thinks very hard about how a lower value might be achieved. Moreover, the techniques which are prescribed by the government may be economically (and even ecologically) less appropriate than another proce-

dure. These and other disadvantages are comparable to someone demanding: 'Because food or computers are of great importance for the population, the government ought to determine in what numbers and quality they must be produced.' Such a claim would be followed by instant criticism, and rightly so.

All aspects of the economy and the environment throw up the question whether the state should issue detailed regulations or rely on personal initiative and market forces. When it comes to food and computers, society is overwhelmingly in favour of market forces. The environment, though, is a completely different issue. This is not easy to understand, however, because the quality of the environment is also an important commodity in limited supply.

Despite the obvious differences between a computer and clean air, there is a whole catalogue of good ideas on how to make market forces work for the supply of environmental goods. Emission certificates, emission charges and the environmental liability law are possible ways of doing this.

Certificates enable companies to trade the right to certain emission quantities freely among themselves. The environmental policy objective is met because the number of emission rights issued is limited to what is socially tolerable. This is preferable to regulations because businesses which can decrease their emissions cheaply, can sell their rights to companies whose cost of preventing environmental damage is higher. This is extremely good news not only for industrialists but for the national economy as a whole: after all, environmental protection is more



successful and costs less when the associated charges are intelligently distributed among companies with different cost structures than when rules and regulations are imposed. In the →EU, a system of ‘emission exchange’ came into force in January 2005. It is hoped that this will achieve the climatic policy goals of the European Union as economically as possible. This system incorporates numerous elements of the concept behind the emission certificates and puts them into practice.

Emission charges are equally preferable to regulations. If a business has to pay emission charges, it means that emissions have been given a price. It is true that the charges are not market-related prices but are dictated by the government, but still the desire for profit stimulates entrepreneurial creativity with the result that the costly emission factor is rationalised away. This brings a kind of business energy into environmental protection, which one can only dream of when regulation policies are used.

Meanwhile, many industrialised countries have adopted taxation systems with ecological components. In a similar way, the liability law makes the entrepreneurial self-interest serve environmental protection. The best way to avoid being sued for damages is using good environmental protection technology. If the entrepreneur is insured, the insurance company will diligently monitor the state of the environmental technology used by the insured party. The Law Concerning the Liability Regarding the Environment (*Umwelt-haftungsgesetz*) of 1991 puts certain aspects of this idea into practice.

As far as the successful application

of free market instruments in environmental policy is concerned, caution is recommended. Politicians are in the habit of labelling laws and other directives as market-friendly, when in actual fact they are predominantly antagonistic to the market. The German Waste Water Charges Act, for example, has been formulated in such a way that the environmental protection stimulus is almost entirely lost. The same criticism is levelled at the Law Concerning the Liability Regarding the Environment. Much, therefore, especially in the area of the environmental policy instruments, remains to be done. There is still a long way to go before an ecologically sensitive →market economy has been perfected.

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Alfred Endres

### Environmental protection objectives

The first, and to this day the most important, environmental policy objective is the reduction of air, water and soil pollution (→environmental impact). It has to be taken into account that environmental protection does not only bring benefits (e.g. in the form of clean air), but also costs (e.g. the costs of installing filtering units). Thus the goal of environmental policy cannot be the total avoidance of any environmental

impact; this would be associated with extremely high costs and would therefore be uneconomical.

It is rather about weighing up the benefits and costs of environmental protection against each other, and making the optimal quality of the environment a reality. For example, the sulphur dioxide levels in the air should not be brought down to zero, but only to the point where the costs of the avoidance of an additional ton of sulphur dioxide corresponds to the benefits which would result from this additional emission reduction.

In reality, it is very difficult to make environmental policies so optimal (or efficient). It is especially true that the benefits of environmental protection cannot be accurately measured and translated into monetary units (something that is indispensable for the so-called cost:benefit ratio). This is why environmental policy can usually only pursue the more modest goal of minimising costs. This entails giving up the goal of an optimal-quality environment in favour of a certain degree of environmental quality as a political requirement that has to be realised at minimum cost.

In the case of the sulphur dioxide emissions, the first step is for the government to set a maximum emission level (which will not be optimal), then it has to decide which instruments (e.g. regulations, charges or certificates) will bring about the necessary reduction of the sulphur dioxide emissions in the most economical way.

The selection of instruments (→*environmental policy: instruments*), as opposed to the definition of the objectives, has to be seen as the most impor-

tant economic task within the field of environmental policy.

During the past few years, and having been extremely successful in bringing down environmental pollution, environmental policy has increasingly turned its attention to new tasks: apart from improving the quality of the air, water and soil, the more economical use of natural resources is next on the agenda. Here, a distinction is made between non-renewable resources (such as oil and gas supplies) and renewable resources (such as animals and plants). In this regard, the goal of sustainable development plays an important role. This generally refers to an economic development, which gives equal consideration to the needs of the present and of future generations.

Sustainability therefore requires both a clean environment (or at least one that is not too polluted) and the preservation of natural resources for posterity. Environmental policy must therefore guarantee that these resources are handled responsibly and that the predatory exploitation of raw materials, the extermination of species and the destruction of ecological systems are prevented (→*resource protection*).

It is true that in Germany, environmental protection is highly regarded; it has been incorporated into the Basic Law (Article 20a) as a national objective. But so far there is no environmental policy that is truly focused on sustainability, that takes the connections between the different environmental policy areas into account and that is based on concrete, verifiable objectives.

Instead, nature conservation, soil, water and climate protection, air pollution control and health protection are

being implemented more or less independently of one another, and the formulation of the objectives – with a few exceptions (such as the marginal emission limits for air pollutants in the Technical Instructions – Air) – remains vague (such as when the Federal Soil Protection Act calls for ‘the lasting protection of the functions of the soil’).

For as long as a concrete, logical target system is lacking in environmental policy, it will not be possible to implement an environmental policy that is both ecologically effective and economically efficient.

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Fritz Söllner

### Environment-oriented management

Between the early and the mid-1980s, the business community – first in northern Europe and later in the United States and southern Europe – began to recognise that environmental protection had become a strategic task which involved far more than the installation of filtering equipment downstream. The practical side of running a business showed that it was not

only important to observe numerous environmental laws while maintaining profitability, but that a way had to be found for enterprises to marry environmental protection with successful company management at their own initiative.

To this end, business science degree courses soon introduced ‘environmental management’ as an additional academic subject. The core concept emerging from the research was that in order to have the desired effect, environmental protection had to be integrated with the other objectives, processes and functions of business management.

In a market economy, environmental protection can never be the dominant goal of an enterprise. But an →*enterprise* can, for its own good, set itself economically acceptable environmental targets in order to increasingly lighten the ‘ecological footprints’ of its products and production processes. Economically, this will be driven by potential savings (savings on waste disposal and energy) or ecological product characteristics (for instance, food items free of pesticide residues). Without measurable targets, environmental protection remains noncommittal as a management task (in keeping with the old adage ‘what’s measured gets managed’; →*business accountability*).

To reach their goals, enterprises (as always) need strategies, information, management systems and instruments. The strategy is often formulated as an ‘environmental strategy’ because, both internally and externally, this is easier to communicate. Apart from objectives, such a strategy requires planned measures (e.g. investments for the setting of

environmental standards for industrial plants, product innovations) and the allocation of resources.

Although the concept of communicating the issue plays a role, the environmental strategy – if it is to be really effective – has to be applied to the ‘ordinary’ business procedures (for example, the product development process). Whether or not environmental objectives can be achieved (e.g. the disposal costs, or the energy efficiency of the product), depends on their integration in these processes. Therefore, the environmental objectives have to be broken down into these functions (i.e. described in detail), so that they can be incorporated into the processes (e.g. the objective ‘waste reduction from production process  $z$  by  $x\%$ ’ is written into the business plan in this concrete form and is listed there together with the necessary measures and resources).

This procedure is helped by shared background information (environmental database) where the relevant emissions and environmental effects are captured, and which show where exactly the strategic priorities ought to be positioned.

Environmental management systems (such as the ISO 14000 or the European directive on voluntary participation in the Environmental Management and Auditing System, EMAS) help to define areas of responsibility and describe informational and organisational processes which are necessary if a responsible implementation of the agreed environmental protection objectives and strategies is to be ensured.

To this end, special instruments have been developed (e.g. environmental controlling, the ecological balance)

which serve to ensure that environmental protection is managed as professionally as other areas.

Apart from the unpredictability of economic trends and developments, and the resulting short-term thinking which predominates in business, the hedonistic nature of modern consumer behaviour (i.e. pleasure-seeking and therefore often environmentally harmful) and the strict, confusing and often anti-progressive government regulations are the main reasons why business is not more committed to environmental management.

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Ulrich Steger

### European Central Bank, German Federal Bank

The banking and monetary policies are vested in the central banks. They are at the top of the hierarchy of the banking system and regulate the money supply of their economies. For the first 50 years of the existence of the Federal Republic of Germany, the German Federal Bank, with its headquarters in Frankfurt, was responsible for the German banking and monetary policy. In early 1999, the currency sovereignty shifted to the European System of the Central Banks (ESCB). In the European Monetary Union (EMU), the national issuing banks of the member countries became an integral part of the euro system, headed by the European Central Bank (ECB), like-

wise with its headquarters in Frankfurt (→*European monetary policy*).

The prime objective of the ECB – as before that of the German Federal Bank – is to ensure →*price level stability* in its currency area. By safeguarding purchasing power, the ECB makes its contribution to a lasting and satisfactory economic growth as well as a high level of employment. In the long run, competition can function only if price levels remain stable. Inflation and deflation are equally responsible for distortions in the production, consumption and distribution of the economic product and are thus detrimental to prosperity (→*conflicting aims in economic policy*).

In order to achieve its ultimate objective of price stability, the ECB has monetary policy instruments at its disposal (→*European monetary policy: instruments*). These were developed in line with the practical monetary policy experience of the issuing banks in the euro system. Market-orientated instruments are paramount, since they are mostly in harmony with the existing competition system in the world of finance. Through so-called main refinancing business, the banks can once a week, and for a period of one week, get the liquid funds they need (central bank money) by approaching the ECB with bids. Besides, the ECB – also through bidding – offers long-term refinancing for three months.

For special, short-term liquidity requirements or for the investment of surplus liquidity, the business banks can fall back on two permanent facilities: the marginal lending facility (the banks need liquidity and can obtain it from the ECB at a higher interest rate than through the main refinancing business)

and the deposit facility (the banks have surplus liquidity and can invest it at a lower interest rate with the ECB). The interest rates for these two instruments form a passage within which the overnight rates for day-to-day money fluctuate.

The minimum reserve serves as a buffer for the daily fluctuations which the business banks have to keep at the ECB and which they have to attain as a monthly average. The minimum reserve is calculated as a certain portion of the short-term client deposits with banks, and can be varied by the ECB in order to achieve monetary policy goals.

The decisions on the deployment of the monetary political instruments are made centrally by the ECB Governing Council and they are implemented in a decentralised manner by the participating national central banks. The ECB Governing Council is made up of the six members of the board of directors of the ECB and of the presidents of the national central banks of the euro area.

In order to avoid conflicting aims, particularly between the governments and the ECB, whose primary commitment is price level stability, the ECB Governing Council is independent in its resolutions. Its members are not authorised either to ask for, or to accept, instructions from a third party. Furthermore, all political institutions are obliged not to exert pressure on the ECB (Article 108, ECC). As an additional protection against political lobbying, the ECB and the national issuing banks are not allowed to grant credits to EU institutions or to national governments.

Tasks, objectives, instruments and competences of the ESCB correspond –

as at the Federal Bank before – to the requirements of a →*social market economy*. The priority of the monetary policy demanded by Walter →*Eucken* is guaranteed through the creation of an efficient institutional framework.

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## European Economic and Monetary Union

The European Monetary Union (EMU) has been in existence since 1 January 1999. The issuing of coins and banknotes on 1 January 2002 concluded a process of integration which had become official policy as long ago as December 1969 (→*integration*).

In terms of integration, a monetary union is a considerably more far-reaching objective than a free trade zone or a customs union, affecting as it does the very core of the financial and monetary sovereignty of the nations concerned.

A monetary union can take either of two forms: either it will have irreversibly fixed exchange rates between the participating countries or it will adopt a uniform currency. The European Union (EU) decided on the

second option, which has more profound political and psychological consequences, and represents a more definitive form of integration. In both forms of monetary union, national finance policies have to be replaced by a centralised finance policy.

In the case of the EMU a European Central Bank (ECB) was established with the →*German Federal Bank* being just one of the national central banks with voting rights. Beyond this, the German government has given up its right to alter the exchange rate for good. The euro exchange rate is determined by a European Community policy committee.

It has become customary to refer to the European Economic and Monetary Union (EEMU) as something akin to Siamese twins. This is not the case – widely differing sectors of the economy are regulated without a mutual causal relationship. While an economic union without a monetary union is quite feasible, a monetary union without an economic union will never work. This means that the economic union should come first and the monetary union second.

An economic union has been achieved when conditions between the member countries in the integrated area resemble those of a domestic market. This means that of the five constitutional liberties of an economic and monetary union, four have to be granted by the framework of the economic union and one by the framework of the monetary union.

Economic union freedoms are freedom of trade, freedom of the service industry, free movement of labour and the freedom to establish companies.

The monetary union freedom is freedom of financial and monetary transactions.

In the areas of the national economies to be liberalised, the following integration requirements have to be fulfilled:

- The creation of a domestic market for goods and services.
- Companies' choice of locality.
- A flexible labour market.
- Ability to adapt to the growing competition in the abovementioned markets.

On the monetary side, a community financial market has to be created that allows for the easy conversion of the common currency into other currencies.

A common financial and monetary policy demands the coordination of the economic policies of the member countries, assuming that they – as regulated in the EU contract – essentially remain under national determination and are regarded 'as an issue of common interest'. Otherwise, financial and monetary policy is disrupted or impossible (*see figure, next page*).

These requirements of an EMU demonstrate the depth of integration aimed at as well as the considerable political consequences to which an EMU gives rise. This fact justifies the question whether a political union (previously established or created simultaneously with the EMU) is necessary in order to invest the EMU with lasting stability.

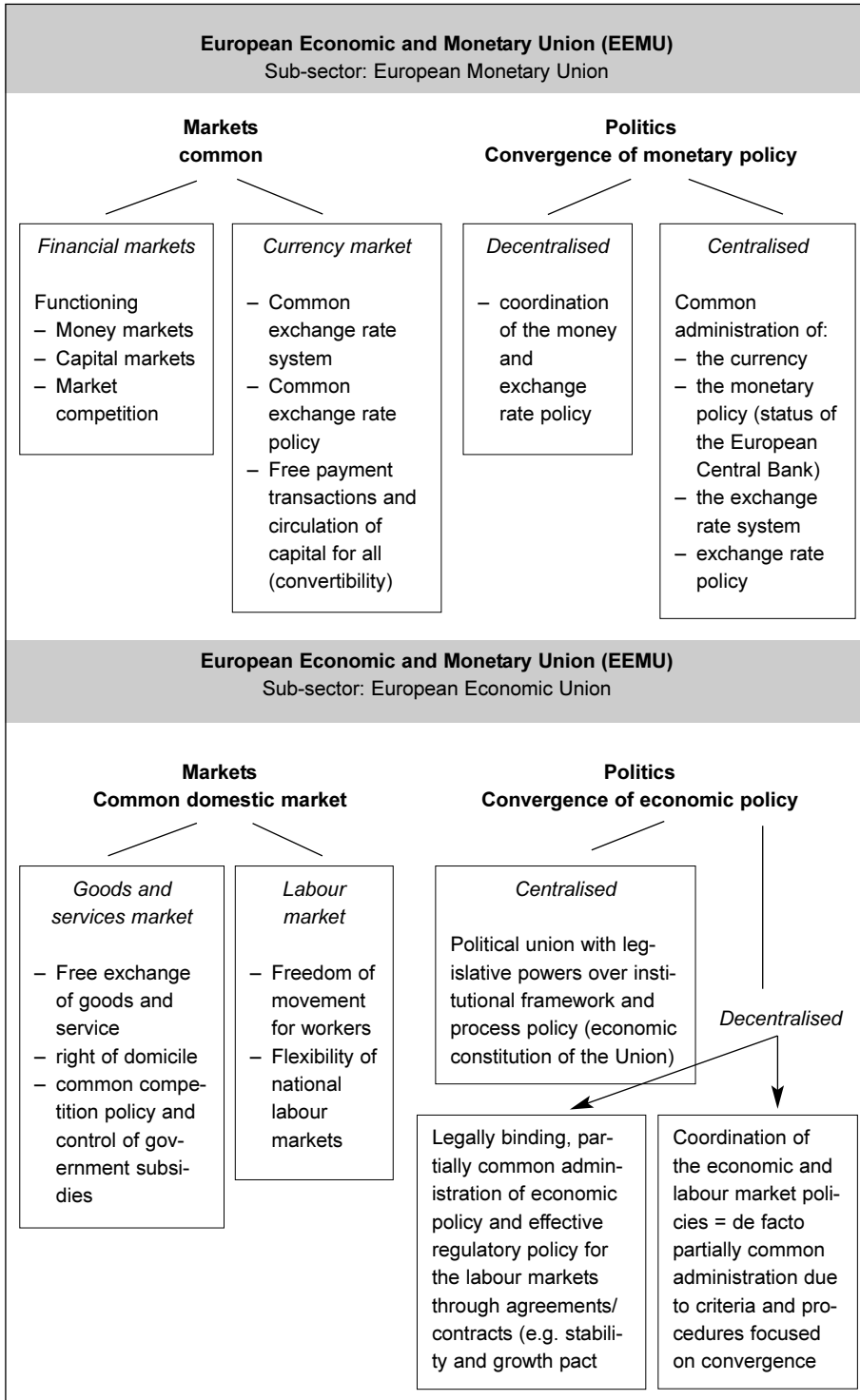
Earlier attempts to establish an EMU failed because the economic, monetary and political consequences of this process of integration had not found acceptance. In addition, there were insurmountable differences concerning the details of financial and monetary policy: monetary stability as (sole) objective; (in-)dependence for a European central bank; convertibility at the beginning/the end? This is why the Den Haag initiative ended in failure (1–2 December 1969) as long ago as 1971–1972 (Willgerodt et al., 1972).

The introduction of the European Monetary System (EMS) in March 1979 did not target the European economic union directly, but it still failed to pave the way for progression from the first to the second institutional level of integration. The successes of the EMS were due to a reversal of the rules and to the positive anchoring role of the Deutschmark and the German Federal Bank.

The third attempt, officially initiated in 1988, led to the government conferences about the European Monetary Union and the political union. They were brought to a conclusion at Maastricht in December 1991, resulting in far-reaching amendments to the European Community contract and in the creation of the European Union Treaty. The monetary union and its policies were ratified and implemented there and then.

Why was it that this most recent attempt ended in the successful creation of the EU?

- The most important – and frequently omitted – prerequisite for the existence of an economic union was





already in place, having been started and made a reality in 1987 with the programme Domestic Market '92.

- The German →*reunification*, coupled with the determination of the federal government to demonstrate its loyalty to the West, led to the offer to relinquish the anchor currency Deutschmark in the context of an EEMU in favour of a common currency. This suited other EC states and their political ambitions. Among other reasons, they aspired to an EEMU as a way of ending the dominance of both the Deutschmark and the German Federal Bank.
- The process of integration started on 1 July 1990 with the transition to currency convertibility.
- The ECB was solely responsible for the codification of the creation and maintenance of price stability and succeeded in doing so. Furthermore, the ECB and all national central banks became independent and therefore no longer subject to instructions from political institutions (→*European monetary policy*).
- The coordination of the economies was greatly improved. In order to qualify for the monetary union, each country has to fulfil criteria of convergence (stable prices, stable exchange rates, stable interest rates, solidity of public finances – budget deficit, indebtedness). Particularly sensitive and politically important criteria related to public finance were clarified and tightened in a growth and stability agreement in 1997,

which is binding for all members and also for the monetary union.

- The economic orientation was clarified as well. As a result, price stability remains a priority, but not only regarding financial policy. It is equally relevant for exchange rate policy and economic policy. The Maastricht accord emphasises repeatedly that economic policy has to be in harmony 'with the principle of an open →*market economy* with free →*competition*' (Articles 4, 98, 105).

What is still lacking? Many details have been found wanting, but specifically two areas (might) cause problems:

- Attempts to make definitive progress on the road towards a political union failed, not only in Maastricht but at the government conferences at Amsterdam (1997) and Nice (2000). The next government conference on the political union has already been planned but the massive EU enlargement has increased, rather than decreased, the problems.
- The conceptualisation of the economic union was too narrow from the start. Politically, the economic interdependence between the commercial sector (trade and service industry, freedom to establish a business) and the labour market was overlooked. The national labour markets were not included in the reorganisation and integration of the market economy and might turn into a stumbling block.

There are many reasons for the

sceptical attitude towards the EEMU – some justified and others imaginary. There is consensus that this is a political undertaking which will require enormous political courage and the will to adjust, if besides the economic objectives the political aim – the stabilisation of the European peacetime order – is to be achieved.

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### European monetary policy: Actors

The eurosystem is responsible for monetary policy in the member states of the European Union (EU) that have introduced the euro. It comprises the European Central Bank (ECB) in Frankfurt and the national central banks (NCBs) of the EU member states that have adopted the euro as a common currency. The eurosystem is part of the

European System of Central Banks (ESCB), which includes the national central banks of those EU member states that have not yet adopted the euro.

The eurosystem is managed by the ECB Governing Council and the ECB Executive Board. The ECB Governing Council comprises the members of the Executive Board and the presidents of all the NCBs which belong to the eurosystem. It determines the Community monetary policy according to Article 12 of the ESCB Statutes, including decisions relating to intermediate objectives, key interest rates, and central bank money supply. The ECB Governing Council takes decisions based on majority vote; the president's vote decides in the case of a tie.

The Executive Board comprises the president and vice-president of the ECB and four other members appointed after hearings of the ECB Governing Council and European Parliament by state leaders of the member states that have adopted the euro. The Executive Board implements the decisions of the Governing Council, and it gives the necessary instructions to the NCBs.

The ESCB is governed by the ECB Governing Council, the Executive Board and the General Council (extended Governing Council), which comprises the president and vice-president of the ECB as well as the presidents of the NCBs of all the EU member states. The General Council coordinates the monetary policy of the eurosystem with the NCBs of the member states that have not yet adopted the euro.

Article 7 of the ESCB statute guarantees the independence of the decision-making bodies. Thus 'when

exercising the powers and carrying out the tasks and duties conferred upon them ... neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body’.

In particular, this independence refers to the pursuit of monetary policy objectives and the decision-making regarding economic →...*strategies* as well as the implementation of economic →...*instruments* and personal independence.

The last point is to be guaranteed through long terms of office for the governors (eight years) and the presidents of the NCBs (minimum five years). In addition, members of the Executive Board cannot be re-appointed. With the desire for an independent monetary policy, the indications from research that the objective of →*price stability* is more likely to be achieved through an independent monetary policy can also be respected.

In order to guarantee price stability, eurosystem policy aims to regulate the available liquidity of all the monetary financial institutions in the euro area; consequently the other monetary financial institutions are considered, in the broad sense, to be economic players. In particular, this includes local financial institutions.

These are enterprises whose activities involve accepting funds or other repayable moneys as well as administering loans, for example banks.

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### European monetary policy: Aims and duties

According to Article 2 of the European System of Central Banks (ESCB) statutes (→...*actors*), the prime objective of the euro system is ‘price stability protection’. This is to assist the euro system in ensuring the stability of the purchasing power of the common currency and to prevent inflation.

The European Central Bank (ECB) considers this objective as met as long as the average annual increase of consumer prices does not exceed the value of 2% in the medium term. The reason behind this projection is the stabilisation of the expectations of households and →*businesses*. However, the ECB does not feel obliged to correct immediately short-term deviations from this objective.

Article 2 of the ESCB statutes continues: ‘Insofar as this is possible without restricting the objective of price stability, the ESCB supports the general economic policy in the Community, in order to contribute to the realisation of the ... jointly agreed objectives of the Community.’

Among these are balanced economic development as well as a high level of employment. However, science and the ECB agree that in the medium and long term these complementary objectives are best met through price stability protection ( $\rightarrow$ *price level stability*). This improves the pricing system transparency on the one hand, and thus the efficiency of the distribution of resources to the place of highest return in each case (efficiency of allocation). Small inflation risks lead to a lowering of the interest levels in the long term and have a stimulating effect on investment and  $\rightarrow$ *employment*. Furthermore, price stability means that household and company assets are not deployed as a hedge against inflation, but are utilised productively. Finally, it also prevents an arbitrary redistribution of assets and  $\rightarrow$ *income*, strengthening the Community's internal social cohesion.

Thus, the price stability objective is considered as being compatible with economic stability and a boost to the labour market. The ECB considers it pointless to attempt to lower  $\rightarrow$ *unemployment* in the short term by means of financial policies that go against the price stability objective, since such policies endanger the conditions for stable economic and employment growth, at least in the medium term ( $\rightarrow$ *conflicting aims in economic policy*). The prospects of lowering unemployment and of stabilising the  $\rightarrow$ *economy* through monetary policies are very limited, even in the short term, since the monitoring of business cycles is never absolutely correct and is always subject to a time lag, and since financial policy does not have a perfectly predictable delayed effect on employment and the economy.

Besides the formulation and implementation of monetary policy in the Community, according to Article 3 of the ESCB statutes, foreign currency transactions, the administration of the official currency reserves of the member states and the promotion of a smoothly operating money market count among the euro system's responsibilities. Moreover, the ECB, according to Article 4 of the ESCB statutes, also occupies an advisory function and has to be consulted on all legislative proposals of the Community. It is entitled to voice its opinion in disputes with organs and institutions of the Community as well as national authorities, whenever its area of responsibility is involved.

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### **European monetary policy: Instruments**

According to Articles 18 and 19 of the European System of Central Banks (ESCB) statutes, the instruments at the disposal of the ESCB ( $\rightarrow$ *European monetary policy: actors*) consist of open market operations, standing facilities and minimum reserves. The principal instru-

ment comprises the following four open market operations through which the euro system grants loans to financial institutions: by means of its main refinancing operations, the euro system covers the bulk of the financial sector's liquidity requirements; at the same time its terms (interest rate, quantity of allocation) are meant to signal the course that monetary policy is intended to take.

Longer-term refinancing operations ensure the provision of long-term liquidity without a signal effect; fine-tuning operations are used by the euro system to balance unexpected liquidity fluctuations and to stabilise interest rates, while liquidity distribution within the financial sector is regulated by structural operations.

In order to ensure the liquidity of the financial sector through open market operations, the euro system and the financial institutions usually arrange restricted transactions such as repurchase operations or pledged securities operations. For repurchase operations, the euro system will buy securities from financial institutions while at the same time concluding a repurchasing agreement with them, obliging the financial institutions to repurchase the securities at a later time and to refund the Central Bank money.

Where pledged securities operations are concerned, the euro system will lend against securities owned by financial institutions without any property transfer taking place. The euro system also concludes definitive transactions, where securities are bought or sold outright and where time limits do not apply (outright open market operations).

In addition, the euro system carries out foreign currency swap operations, where euros are bought (or sold) in exchange for a foreign currency, under the concurrent agreement to sell (or buy) euros at a later, fixed point in time, in exchange for foreign currency. In order to absorb market liquidity, the euro system is able to issue its own debenture bonds as well as to accept fixed-term interest-bearing deposits from financial institutions.

All open market operations with financial institutions are executed in the form of bidding processes (tenders), either as fixed-rate tenders or as variable-rate tenders.

For fixed-rate tenders, the financial institutions have to indicate the amount of Central Bank money they require in the form of a bid, which has to be submitted at the interest rate set by the euro system. If the sum of all the bids submitted by the financial institutions exceeds the amount of Central Bank money the euro system is prepared to lend, the final allocation to the financial institutions will be based on a quota system. If, for example, all the bids received add up to €800 billion and the euro system does not wish to lend more than €80 billion, each financial institution will receive one-tenth of its original bid.

For variable-rate tenders, however, the financial institutions are not only obliged to indicate the size of their bids, but also the level of interest at which they are prepared to maintain them. The final allocation then depends on the interest rates submitted together with the bids. If, for example, the allocated amount is once again €80 billion, and Bank A has submitted a bid of €30

billion at 5%, Bank B a bid of €50 billion at 4% and Bank C a bid of €40 billion at 3%, Bank A receives €30 billion in Central Bank money and Bank B €50 billion – their bids being the highest – while Bank C receives nothing.

When the allocation is made at a uniform interest rate, it is referred to as the Dutch system; if, however, financial institutions receive Central Bank money at their own, individually submitted interest rates, the allocation is made according to the American system.

Besides open market operations, the euro system also offers so-called standing facilities which financial institutions can use if they wish. These provide extremely short-term liquidity as well as liquidity absorption. This liquidity is offered by a marginal lending facility, which gives financial institutions access to unrestricted amounts of Central Bank money at a fixed euro system interest rate for the coverage of short-term liquidity requirements. Liquidity absorption is provided by a deposit facility, which allows financial institutions to invest surplus liquidity with the national central banks at a prescribed euro system interest rate.

In conclusion, the euro system has a minimum reserve instrument which compels the financial institutions located in the euro currency area to deposit interest-paying minimum reserves to the amount of (currently) 2% of their liabilities, with the national central banks. This instrument is intended to aid the stabilisation of Central Bank interest rates as well as to increase the demand for Central Bank money. The minimum reserve requirement applies for the financial institutions' liabilities

such as deposits, debentures and issued money market papers, with the exception of liabilities towards other financial institutions bound by the minimum reserve legislation.

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### European monetary policy: Strategies

A monetary policy strategy describes the long-term decision-making process regarding the deployment of monetary policy →...*instruments* aimed at the achievement of monetary policy objectives.

In this respect, the monetary policy strategy has to fulfil two principal tasks:

- Lending structure to the decision-making process on monetary policy and providing the ECB Governing Council (→...*actors*) with the information it requires for this decision-making process.
- Strategy that serves as a means of communication and contact with the public and thus renders financial policy more plausible.

Through its monetary policy, the euro system is pursuing a stability-oriented strategy which is, above all, supposed to fulfil various criteria. The main criterion is effectiveness, meaning that only the strategy will be applied that is best able to achieve the objective of monetary policy.

At the same time, the strategy is supposed to signal to the public a realistic commitment to this objective. This requires clear and comprehensible wording as well as transparency and easy accessibility for the public; moreover, the public must be given the opportunity to evaluate the implementation of monetary policy as well as its positive outcomes, by measuring them against the monetary policy objective.

Essentially, the euro system's stability-oriented strategy consists of two elements. The first is the quantitative determination of the principal objective of →price level stability by means of the projection of an inflation target of 2%. The other element consists of the two-pronged support for the strategy.

The first pillar comprises an economic analysis of the recent economic development and its short- and medium-term risks for price level stability. The second pillar is the monetary analysis as a basis for the prognosis of the medium- and long-term inflationary trend. Scientifically, this is based on the view that inflation is a monetary phenomenon which results from an excessive money supply increase relative to the actual economic →growth.

By using the monetary analysis the ECB tries to check the short- and medium-term inflation prognosis resulting from the economic analysis, taking into account a longer-term perspective. For

this reason, the European Central Bank (ECB) has declared its intention to steer the intermediary objective of money supply in such a way that the ultimate objective, which in financial terms is 'price level stability' (→...*aims and duties*), is most easily reached.

To this end, the ECB chose as intermediary objective and as its parameter, a comparatively loosely defined money supply comprising not only the circulation of cash and the usual deposits in financial institutions, but also money market bonds and bonds issued by other monetary financial institutions (referred to as money supply M3). The ECB's justification for choosing money supply as its intermediary objective is its suitability as an indicator of future price trends and the fact that it is easily controllable through the euro system.

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### **EU: Agricultural policy and enlargement east**

Although in many countries →agricultural policy is considered to be a sensitive domestic affair, the member countries of the then newly founded European Economic Community decided at the

very outset of European →*integration* to give up their national agricultural policies and replace them with a common agricultural policy that included a uniform agricultural commodities market.

This was not an obvious development by any means, as the individual member countries ran their previous national agricultural policies along quite different lines. However, free agricultural trade between the member states in the context of a common policy was an important goal – especially for France, since that country hoped that this would compensate for the opening of the French market to the import of industrial goods from Germany.

During the establishment of the common agricultural policy after 1960, common agricultural price levels had to be agreed between countries with previously low agricultural prices such as France, and high agricultural prices such as Germany. After harsh arguments, the decision – particularly due to pressure from Germany – was made in favour of a relatively high price level for agricultural products. As if that were not enough, in the years to come prices for agricultural products in the European Union (EU) continued to be increased. They thereby departed more and more from the level that would have prevailed in markets with no government interference.

As a consequence, agricultural production in the EU rose far beyond the growing demand. This meant that the EU, which at the time of the establishment of the common agricultural policy was still importing agricultural products, started to export all major agricultural products. However, the export of the growing surplus, which in

many cases had to be put into temporary government storage, was not possible without high →*subsidies*, since prices on the international market were markedly lower than the prices fixed by the EU agricultural policy. Therefore, more and more government money had to be spent on the removal of the increasing surplus of the agricultural commodities markets in the EU.

By around 1980, the result was that about three-quarters of the entire EU budget had to be spent on the common agricultural policy and the EU was in a serious financial crisis. At the same time, increasingly harsh commercial conflicts arose between the EU and other countries (particularly the United States), which felt that their agricultural export interests were adversely affected by the EU's market interference.

To prevent these unfavourable consequences of the common agricultural policy, however, initially the symptoms and not the causes were addressed. In 1984 – because of a sharp increase of the budget expenditure, especially in the dairy market – quotas (quantitative restrictions) for milk production were introduced, which prescribed to individual farmers how much milk they were allowed to sell. In an attempt to deal with the surplus problem on the EU grain market, it was decided to take agricultural land out of the cultivation process. It was hoped that it would be possible with measures of this kind to keep the expenditure of the common agricultural policy below an upper limit which had been fixed in 1988.

But reforms targeting the roots of the problem in the form of hyperinflated prices for agricultural products only followed in 1992, after it had



become clear during the Uruguay Round of the General Agreement on Tariffs and Trade negotiations that the talks could not be concluded until the EU had offered to come to an acceptable compromise with its negotiating partners on agricultural issues.

Under EU agricultural commissioner MacSharry, support prices for grain and beef were brought down substantially. To compensate for the income losses of farmers, direct grants out of the EU budget were introduced.

With the Agenda 2000 resolutions, these reforms were taken several steps further under agricultural commissioner Fischler in 1999, when the beef and grain prices were lowered once more and dairy price reductions were planned – in each case with more direct grants for farmers (albeit not making up fully for their losses of income). Through these reforms, the EU has managed to reduce its price support for grain to such an extent that it might be able to export grain without subsidies in the future.

Like the total package of Agenda 2000, these further reforms of the EU agricultural policy helped prepare the EU for the Eastern enlargement (→*EU: enlargement*). This seemed necessary because the new Central European member countries had a considerable agricultural production potential and were thus liable to contribute to a precarious aggravation of the surplus problems in EU agricultural commodities markets and thus to a heavy burden on the EU budget.

In this regard, the agricultural reforms of Agenda 2000 might have been quite effective; although a comprehensive solution to the problems

regarding the agricultural commodities markets, particularly in connection with the Eastern enlargement, meant that further reforms would be necessary. They were required to be undertaken in the context of a 'half-time evaluation' scheduled for 2002–2003. Commissioner Fischler obviously wished to use that opportunity to advance the EU agricultural policy reforms further (→*EU: budgeting*).

The most difficult agricultural policy problem one is going to encounter in connection with the enlargement east has definitely not begun to be solved by Agenda 2000: whether farmers in the member states should also receive the direct grants which were introduced in the EU in 1992, remains uncertain. So far the EU has been of the view that this is neither required nor does it make sense, since these grants were introduced by the original EU in order to counterbalance price reductions which do not occur in the new member states.

The governments of the new member states nevertheless stubbornly insist that their farmers should also receive these grants, and they are able to support their demands with a number of arguments which are hard to reject. The most plausible of these is the argument that →*competition* between the farmers of the original EU and those in the new member states would be severely distorted if the new member states were denied the grants.

A crucial task for the EU agricultural policy is therefore – specifically, but not only in connection with the enlargement east – a decision about the future of the direct grants.

Meanwhile, the direct grants have become the key element of the EU

agricultural policy and already make up half of all the expenditure for this policy, with a rising trend. How the grants will be allocated in future is still unclear. It is, however, likely that the grants will become increasingly less dependent on production but will be more in tune with actual market conditions, that they will be gradually reduced as time goes on, and that eventually completely different incentives will take their place. These are supposed to reward the sort of social achievements that agriculture provides, especially for the environment and regional development.

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## EU: Budgeting

A 'financial constitution' comprises all legal regulations which define the competence of public authorities to handle income and expenditure. The 'financial constitution' of the EU consists of regulations for the acquisition of financial means and instructions on how and in which political spheres these should and/or can be used.

### *EU income and expenditure responsibilities*

A financial constitution can be divided into active and passive financial equali-

sation. Active financial equalisation entails the assignment of public revenue. Passive financial equalisation, by contrast, is defined as the assigning and distribution of public responsibilities as well as the manner of their execution. Since political responsibilities are always connected with expenditure, both terms (responsibilities, expenditure) can be used equally. The relationship between own revenue and expenditure, which can be independently determined, reflects the degree of financial autonomy of a social organisation. For the European Union (EU), the allocation of responsibilities and financial means to union level always simultaneously represents a piece of political integration.

The original integration of sectors of the economy was – thanks to the removal of barriers to trade – followed by the gradual shift of individual member states' policies to the level of the EU. This means that passive financial equalisation continued to grow (Article 3 ECC). This includes the right to take decisions on the way in which the assigned responsibilities are implemented (decision competence), the way in which tasks are carried out (executive competence) and how money is spent for this (financing competence).

In the event of the expenditure increasing, the revenue has to grow too. This entails an expansion of the active financial equalisation. This part of the financial constitution requires clarification as to the sources of revenue (decision competence), the right to impose revenue (tax setting competence) and the right to dispose of the proceeds gained (competence to use proceeds).

Articles 268-280 of the European

Community Treaty can be interpreted as the financial constitution in the narrower sense. The EC merger treaty of 1965 meant that the administrative budgets which had originally been drawn up separately for the individual sections of the European communities were replaced by a uniform budget. In 1970, the research and investment budget of Euratom was included in the general budget. Today, there is an EU budget, a European Community for Coal and Steel (ECCS) operational budget, the European Development Fund and the plan regarding EU borrowing and lending, which comprises the European Investment Bank as well as the New Community Instrument.

In terms of expenditure, a distinction has to be made between mandatory and non-mandatory expenditure. Mandatory expenditure arises from obligations of the EU Treaty, from derived rights, from agreements and understandings, as well as from international treaties and contracts based on civil law. The European Council as the highest organ of the EU is responsible for their implementation.

Regarding non-mandatory expenditure, the European Parliament has the decision-making power. The EU Commission is authorised to allocate these means to individual projects in the spheres of structural policy, research and technology as well as developmental aid. In connection with the lack of democracy within the EU which has been discussed, the allocation of expenditure for the common agricultural policy (CAP) as a mandatory expense is problematical, since it means that 45% of the expenditure has been removed from parliamentary control.

When the EU expenditure is interpreted as an offer of public goods by the EU, another picture emerges. In that case, policy spheres and categories of expenditure at Community level are one and the same. This is reflected in the budgets. The most important items are CAP expenditure and the costs of the structural and coherence policies. In the course of the Eastern enlargement, financial aid in the context of the integration strategy for the membership candidates must be added to the account.

Moreover, the EU allocates funds to the internal (cooperation in the spheres of the judiciary and domestic affairs) as well as external (joint foreign and security policies) policy fields. Besides the administrative costs, a mere 5.1% of the total expenditure has to be covered.

Until 1971, the revenue of the European Community (EEC/EC) was made up of financial contributions from the member countries which were tied to a specific purpose, as well as revenue distributions on the production of coal and steel.

On the basis of Article 201 of the EEC contract, in 1970, the communities were granted competence for their own resources and, by 1975 the financing system had gradually been changed over to these sources. Since that time, the key concept has been 'own resources'.

The means consist of fiscal revenue at the disposal of the Community for the purpose of covering costs. The total volume of revenue, and thus also expenditure, is currently not allowed to exceed 1.27% of the Community gross national product (GNP). The Own Resources System includes genuinely

own resources and contributions by EU members.

### *Genuinely own resources*

- Agricultural levies and agricultural customs duties as well as the sugar and iso-glucose levy (production and storage levy in the context of the Common Market regulations for sugar).
- The customs duties that are imposed, according to the Community customs tariff, on imports from non-member states.

### *Contributions by the EU member states*

- Value-added tax (VAT) own resources, which result from the application of a uniform rate (2007: 0.33 percentage points) to a particular uniform basis of assessment (no more than 50% of GNP). Due to political pressure, specific regulations exist for certain countries (e.g. the United Kingdom, Spain).
- GNP revenue, which was introduced in 1998 as an 'additional' source of income, i.e. as residual funding for the Community budget. It is calculated with the help of a rate that is reassessed annually during the budget debates and applied to the total of the GNPs of all member states.

The most important sources of income for the EU are GNP and VAT own resources.

Meanwhile, the specific regulations for individual countries, allowances for the non-uniform economic structures and stages of development in the mem-

ber states, the backflow from the CAP as well as from the structure and the coherence funds have led to difficult net positions. Certain economically advanced and productive member states such as the United Kingdom, France and Italy form part of the net recipient countries.

To generate new revenues and as a means to strengthen the competence to use proceeds, an EU tax has been repeatedly debated. In defending it, both the Commission and the European Parliament have argued that it would instil a greater sense of shared responsibility and make the European tasks more tangible. Besides an increase of national VATs, among other things, the emission of carbon dioxide or the consumption of certain goods and services (tobacco, alcohol, mineral oil, telecommunication) have been suggested as tax subjects. The reason why an EU tax has so far been rejected might be the perceived threat of a 'tendency to an open transfer union'.

### *Budget and financial prognosis*

Budget creation as a decision-making process on EU income and expenditure:

The EU Commission submits a preliminary draft budget to the EU Council. On account of the different categories of expenditure (mandatory and non-mandatory), the European Council and the European Parliament jointly make up the Budget Authority. Both institutions communicate on a regular basis.

Subsequent to the recommendations of the Council, the preliminary draft budget becomes the budget proposal, which goes to Parliament for its

first reading. At this point, suggestions for amendments to mandatory and non-mandatory expenditure can be submitted.

During the second reading, the Council has authority to finalise the mandatory expenditure. Parliament, in a concluding second reading, has the task of finalising non-mandatory expenditure. The only way Parliament can influence the mandatory expenditure is by rejecting the budget in its entirety.

After the parliamentary statement on the budget proposal, the president of the European Parliament accepts the proposal. At this point, the budget is ready for implementation.

The monitoring of adherence to proper budgetary procedures falls on internal authorities and on the European Auditor General as the external inspector. Beyond that, efficiency checks are carried out based on the evaluation of individual projects. The discharge of the Commission by the European Parliament completes the budgetary cycle. Such a discharge has not, however, been granted for several years. The fact that this right is still a powerful way of making EU policy more transparent was demonstrated by

the collective resignation of the Commission under its president, Jacques Santer in 1999 due to the refusal of release by Parliament after irregularities in the use of funds had been discovered.

### **Outlook**

Important steps regarding the EU's budgeting are Agenda 2000 (adopted at the Berlin Summit of the European Council in March 1999) as well as the approval by the European Council of the Treaty of Nice (December 2000).

It is mandatory that all EU members make their contribution to the running of the Community. To what extent members are entitled to a share of the revenue depends on the criterion of their economic performance. To what extent members have to contribute to the expenditure (returns), is dependent on how economically developed they are (structural policy) and on what proportion of their GNP comes from the agricultural policy. As a consequence, there are different net payer and net recipient positions.

While the net recipients are more inclined to defend the status quo of the financial constitution, the net payers are pressing for reforms. And despite vocif-

**EU Budget 2007: Resources by type of revenue**

<i>Type of revenue</i>	<i>€ million</i>	<i>%</i>
Agricultural duties and sugar levies	2,019.80	1.7
Customs duties	15,287.90	13.2
VAT based resource	17,827.41	15.4
GNI based resource	79,152.84	68.5
Miscellaneous + surpluses, balances and adjustments	1,209.27	1.0
<b>Total</b>	<b>115,497.22</b>	<b>100</b>

*Source : European Commission: Budget 2007*

erous declarations of such intentions, Agenda 2000 has to date not brought about any essential reforms. All the discussed reform proposals of the Own Resources System have failed because of the resistance of the net recipients.

A fundamental reorganisation of the expenses (amendments to structural policy, reform of the CAP) did not achieve a majority of votes. The key boundary remains the specification of the upper limit for expenditure of 1.27% of the GNP of the Community (prices date back to 1999). Current expenditure is below this upper limit, which means that there is financial scope for EU enlargement and its projects.

Regarding the Own Resources System, the European Commission was asked to submit proposals on the distribution of liabilities ahead of the next round of negotiations on the post-2006 financial framework. The expenditure arising from the new EU members must also be taken into account. The EU enlargement on the agenda for the next few years will likely increase the heterogeneity of the member countries. This could exacerbate the conflict of interests between the net recipients and the net payers. The new majority proportions could also represent a stumbling block for the reform of the EU financial constitution.

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*Alexander Schumann*

## EU: Competition policy

An important aim of the economic integration of Europe, according to Article 2 of the Treaty establishing the European Community (EC) is to raise 'the standard of living and quality of life' of people. This is the foundation for the creation of the common market, also known as the internal market.

The competition policy instruments are intended to guarantee that the exchange of goods and services within the common market takes place according to the rules of competition ( $\rightarrow$  *supply and demand*). This is not just a political policy of the Community; rather, it has its roots in the legally binding regulations of the European Community Treaty.

The creation of a common market defined by  $\rightarrow$  *competition* in Europe requires that national markets open up by abolishing national restrictions typical of cross-national trade, and that competition be protected from limitations or manipulation by the market participants themselves.

The concept of opening up national markets comes from the explicit definition of the internal market in the Treaty: 'The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of

this Treaty' (Article 2(2) of the EC Treaty).

The member states must abolish any restrictions that limit cross-border economic trade – such as import or export bans, duties on imports or exports, or any other regulations that could restrict transnational economic trade. In particular, a member state is not allowed to discriminate against people or economic goods from other member states. This is legally guaranteed by the prohibitions aimed at the member states that make it unlawful to enforce existing restrictions or to introduce new restrictions to the trade of economic goods between member states.

The effectiveness of these prohibitions is rooted in the fact that the enterprise's, employee's and consumer's scope of opportunity is no longer limited to their respective home country; rather their scope of opportunity now extends to the entire Community. The discrimination and restriction prohibitions form the foundation of economic freedom for the economic participants.

The EC Treaty differentiates between a series of special freedoms; particularly, the freedom to exchange goods and services, employee freedom, the freedom of establishment for →enterprises, the freedom of movement of capital and the freedom of payment transactions. These freedoms, taken together, cover all the economic processes that can be considered transnational.

The 'competition rules' form the foundation for the creation of a competition system within the common market (Articles 81(s) and 82 of the EC Treaty

as well as the control of mergers or 'merger regulation'). →*Competition* is a process of the rivalry of offers and bidders that supports the market opposites regarding the purchase or sale of goods or services.

The instruments (competition parameters) that are implemented for this purpose are diverse (price, quality, quantity, service, innovation, etc.). Competition in this sense arises when the market participants are free to implement diverse competition parameters and, for example, not be bound by restrictions or obligations. Thus, the competition regulations of the Community are against such restrictions or obligations that the enterprises could implement for themselves or others.

Enterprises restrict competition by implementing three strategies:

- Enterprises may coordinate their market behaviour by implementing synchronised competition parameters (for example: pricing agreements, common market division, waiver of innovative product development). Article 81 of the EC Treaty strictly prohibits coordinated activities such as these.
- Enterprises that occupy a dominant market position because they command a high market share (i.e. when they are able to meet the demand alone as a supplier) can obstruct other enterprises in their ability to compete (for example: dumping to obstruct competitors, the use of non-uniform sale prices when doing business with various commercial enterprises, delivery refusal). Article 82 of the EC Treaty strictly prohibits such exploita-

tions of the dominant market position.

- Enterprises that merge into one economic unit can secure a dominant market position. This is fundamentally prohibited by the merger regulations of the EC.

As a final point, the EC Treaty makes reference to the distortion of competition in the common market concerning aid granted by states. An enterprise's market success should be dependent on performance and not on who receives the highest →*subsidies*. A subsidy competition would be incompatible with the common market. Accordingly, the Community enforces strict aid supervision in the member states. Article 87 of the EC Treaty strictly prohibits state aid. Exceptions may be authorised or allowed under certain circumstances.

The implementation of economic freedoms as well as competition regulations falls primarily on the administrative bodies and courts of the member states.

A special characteristic of the Community law is that these rules apply to the member states directly, and that citizens and enterprises can make claims at their local member state administrative bodies and courts to ensure that their rights to restriction-free transnational economic trade and competition can be delivered. The individual freedom of economic action, established through Community law, is the foundation and goal of competition policy.

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Peter Behrens

### EU: Education and research policy

Domestic education systems have generally remained closed to the outside world. This holds true for Germany, too, where it is not easy for European and other foreign competitors to intrude. Only students who can afford to do so privately or who are studying by way of exchange, are able to go abroad.

Europeanisation, and even more so economic and social →*globalisation*, represent enormous challenges for education systems, just like for certain sectors of the service and tertiary industries (telecommunication, energy industry) when they were government-run and enjoyed a captive market.

In the education sector, the impact is even greater because capital markets have become globally integrated, and because investments and jobs are created in places which are economically profitable and where properly trained workers are available, both now and in the future. As a result, job markets are also becoming more international. Beyond that, Europe will gain political and social stability only if there is mutual understanding between people and if their co-existence rests on shared val-



ues. The education system in the United States has achieved astonishing results in this respect, by moulding people of the most disparate backgrounds into a society. The European system, under different conditions, will have to become similarly successful if the →*European Economic and Monetary Union* is to endure, the development of the political union is to continue, and the European economy is to become more competitive at a global level.

But what sort of education policy does Europe need in order to meet these challenges? The Treaty of Rome did not invest the European Community (EC) with autonomous powers in the field of education and research. All the European Commission could do was to submit proposals to the European Council regarding a common vocational education policy and to institute directives on the recognition of diplomas and other certificates of competence. Only with the Maastricht Treaty did this situation change (Articles 126, 127).

The EC was given the task of working towards a high level of educational standards by supporting and complementing cooperation among and the activities of the member states, while at the same time strictly monitoring their adherence to the contents and structure of the education system.

Since then, the Commission has been concentrating its efforts particularly on the languages of the member states, the mobility of learners and teachers, and the cooperation and exchange of information and practical experience. In the field of vocational training, the priorities were to support industrial transformation, to improve

the standard of basic and further education, and to facilitate skills training.

The Treaty of Amsterdam added nothing to this agenda (Articles 149, 150). Its preamble merely stresses the determination of the member states to keep access to education and further education wide open, and to assist their peoples in attaining the highest level of learning possible.

The European Union (EU) has addressed its task by launching numerous programmes (Erasmus, Socrates, Leonardo, etc.), all of which require considerable funding and the necessary administration.

In terms of systematic policy creation, these measures have not generated many tangible results. Notwithstanding the existence of exchange programmes, the EU is a long way off an open education market that ensures free movement across a country's geographical, political and administrative borders. This applies to students as much as to their teachers, professors and other academics who may want to study or work in another EU country. Pupils may go to school abroad, either in or outside Europe, only in the context of a student exchange programme, except in the case of a private school which charges fees. Public sector schools are not motivated to accept pupils from abroad, whether they come from inside or outside Europe, since this merely causes extra work without bringing in extra revenue. In economic terms, this is the equivalent of the primitive system of paying in kind. It is inefficient and prevents the formation of a uniform European education market, which would be sustained and promoted by pupils or students being able

to choose their school or university freely, while at the same time having the means to pay for their place.

It has to be remembered that those who are studying abroad are not occupying a place at school or at university in their own country. This means that they ease the burden on the schools and universities at home. But above all, this system creates healthy →*competition* among the education systems and their specific components, which would especially benefit the younger generation and also the economy and society, and last but not least the taxpayer. Educational institutions would become more highly specialised, while education and training would become more productive. This means that the amount of knowledge communicated by a teacher per lesson would increase, above all in foreign languages which are learnt faster and more easily in the countries where they are spoken and in which countries the student will simultaneously gain a greater understanding of the national culture of other countries. Also, the cost of a place at school or university would go down for the same reasons. Furthermore, the system would be less regulated, giving teachers and lecturers more freedom of movement. More efficiency would be gained because German teachers would be teaching in the United Kingdom, for example, and vice versa. Imbalances (surplus or deficit of teachers or lecturers) and the national salary differences for teachers, university lecturers and other academics, which can be considerable, would be gradually eliminated.

The degree to which the national education industries have divided Europe can be seen from the fact that in

the Middle Ages it was normal for a university to have a body of teachers made up of many different nationalities. Today, the proportion of foreign professors at German universities is not more than 3.5% (including guest professors who only stay for one or two semesters). By contrast, in the German economy, almost 10% of workers are foreigners.

Instead of focusing exclusively on legal interventions and the coordination of the European education policies, there are many arguments in favour of dismantling regulations and restructuring the funding system (→*education funding*) – something that would create a competitive European education market and lay the foundation for a political union. It would also mean that the Bologna Declaration made by the EU in 1999 in which the education ministers of the member countries and a number of European tertiary institutions committed themselves to cooperation, could be more forcefully implemented.

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Ulrich van Lith

## EU: Employment policy

### Objectives

Among the key principles, objectives and activities mentioned in the Treaty

of the European Union and the European Community Treaty is the promotion of a high level of employment in the Community. This is to be achieved through the development of a coordinated employment strategy, in particular regarding the promotion of qualified, trained and flexible workers for unpredictable job markets, which react to economic change.

It is true that the Treaty of Amsterdam brought about the introduction of coordinated measures; but the general competence for measures against →*unemployment* continues to be vested with the member states.

### **Results**

The first instruments:

- The European Social Fund, which was established at the beginning of the 1960s, is the Community's most important instrument for fighting unemployment.

### ***New initiatives during the 1980s and at the beginning of the 1990s***

- →*Employment policies* for special target groups: the long-term unemployed, local employment development and support of small- and medium-sized →*enterprises* (SMEs).
- An information network on the employment policies of the member states and a joint documentation system on employment.
- Promotion of free personal movement and support for workers who are searching for employment in another member state.

### ***Comprehensive employment policy since the early-1990s***

#### *The Essen Summit*

In the 1980s and the 1990s the European Council adopted a number of resolutions on the job situation; but only in 1993 did the EU initiate serious discussions on how to solve the employment problem at a European level. The 1993 Commission white paper on 'growth, competitive ability and employment' (the Delors report), which contains constructive suggestions for the improvement of the job situation, has to be seen in this context.

In December 1994, based on this white paper, the foundation for a common European employment strategy was laid at the Essen conference of the European Council. This was achieved through an urgent appeal to the member states to convert the Essen priorities into programmes that run for several years and are assessed annually by the heads of state and government in the Council.

The five key areas are:

- greater investment into vocational training;
- an increase in the employment intensity of →*growth*;
- lowering of the ancillary costs of wages;
- increased effectiveness of →*labour market policy*; and
- improved measures in favour of the groups especially affected by unemployment (young people, the long-term unemployed).

The effectiveness of these procedures was limited, however, because in contrast to the regulations regarding the →*European Economic and Monetary Union* they had no legal basis in the Treaty; therefore, the European Parliament advocated the inclusion of an employment chapter in the revised Treaty. This was discussed at the government conference of 1996/97.

#### *The Amsterdam Treaty*

With the agreement on the draft of the Amsterdam Treaty in June 1997 and the introduction of a new employment chapter, the EU created a legal instrument for the introduction of a coordinated employment strategy. The member states, which retain their exclusive competence within this area must nevertheless organise their →*employment policies* in such a way that they correspond to the fundamentals of the economic policy of the Community, while job promotion is regarded as a common goal. The Council draws up annual employment policy guidelines, which have to be taken into account in the policies of the separate member states. Furthermore, the European Council of Amsterdam also agreed to the immediate implementation of certain Articles of the new employment agreement without waiting for it to come into force. It declared that an extraordinary European Council conference should be held in November 1997 on employment issues. This was the 'employment summit' in Luxembourg.

#### *The Luxembourg Summit*

The ministers explained their support for the guidelines of 1998. The latter were supposed to be included into the

National Action Plan (NAP) for employment, and envisage four headings, namely:

- greater employability;
- development of entrepreneurial spirit;
- increased flexibility of enterprises; and
- reinforced efforts to guarantee equal opportunities.

The guidelines for 1998 were officially adopted on 15 December 1997. At the end of January 1998, a common framework for the NAP was agreed on. In June 1998 the European Council of Cardiff stated regarding the NAP that the member states were making considerable efforts to strengthen active labour policies. Furthermore, the Luxembourg Summit supported the funding of SMEs and innovative measures in the labour market, as well as an action plan for the European Investment Bank with the aim of securing new loans for SMEs, new technologies and trans-European networks.

#### *The Cologne Summit*

This 1999 Summit followed the Amsterdam Treaty. An 'employment pact' was agreed, which consists of three processes, which have to be coordinated with one another:

- Further development and implementation of the employment policy guidelines, which were agreed at the 1997 Luxembourg employment summit (Luxembourg Process).

- Institutionalisation of a cooperative ‘macroeconomic dialogue’ between the bargaining parties, the →*European Central Bank*, the European Council and the EU Commission (Cologne Process).
- Reforms to promote innovation and improved efficiency of the goods, service and capital markets (Cardiff Process).

All three elements are supposed to be mutually supportive.

### Risks

Different forms of and developments regarding unemployment in the countries of the EU limit the possibilities for a European employment policy, since they also require different methods for the eradication of unemployment that is deeply entrenched. Furthermore, a coordinated employment policy prevents organised →*competition*. Failures in the EU labour markets can therefore not be excluded.

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### EU: Enlargement

The original (1957) European Community of the six founder states – Belgium, Germany, France, Italy, Luxembourg and the Netherlands – had by 1995 been extended to 15 members as a result of three expansion rounds. The first of the new phases (1973) saw the United Kingdom, Denmark and Ireland taking up membership. The second wave, the so-called southern expansion, conferred Community membership to Greece in 1981, and Spain and Portugal in 1986. The last of these three expansion rounds (1995) added the European Free Trade Association states – Sweden, Finland and Austria.

After the radical changes to the international system in 1989/90 and after the end of the East–West conflict, the 1990s presented the European Union (EU) with its first opportunity to consider Europe as a whole – something which was reflected in membership applications from 13 countries, which included 10 Central and Eastern European states.

There were also membership applications from the Mediterranean islands Cyprus and Malta, as well as Turkey which had submitted its application as long ago as 1987. Croatia submitted its application in 2003 and Macedonia in 2004. Switzerland, Liechtenstein and Norway, however, have discontinued pursuit of their membership applications.

The large number of membership applications as well as the hugely differing structural and economic profiles of the aspiring candidates made the EU expansion and the debate it sparked

about which country should be granted membership to the Union at which point in time and under what conditions, one of the most important political questions in Europe.

When the Central and Eastern European states became members of the Community, the population of the EU increased by more than a quarter to nearly 500 million EU citizens, while the gross national product grew by only 15%. The heterogeneity of the Union, too, was markedly increased, considering the Danish per capita income is six times that of Bulgaria and Romania.

Closely linked to the expansion process were the hope of a European perspective and a 'new order' on the continent, as well as a concern about an over-expansion of the Union or that new members might not be able to meet their commitments – all of which could put too much strain on the EU.

In order to support the candidate countries during their preparation for EU membership, in 1994 the EU in the European Council of Essen agreed on an 'approximation' strategy.

In July 1997, the European Commission submitted its statement on the membership applications of the 10 Central and Eastern European countries. In its report, the Commission recommended that membership negotiations be initiated with six states – besides Cyprus also Poland, Hungary, the Czech Republic, Estonia and Slovenia.

After the European Assembly had approved of the six countries in Luxembourg in 1998 (they are therefore also known as the Luxembourg Group), it became possible to initiate membership negotiations in March 1998. In December 1999 the heads of

state and government decided that besides Malta, five further Central and Eastern European states – Bulgaria, Lithuania, Latvia, Romania and Slovakia – had made significant progress, and these countries were then allowed to join the Luxembourg Group in February 2000. It was also agreed in Helsinki to recognise Turkey as a country which was keen on membership, but without entering into any negotiations at that stage.

The basis of an EU decision on the admission of new candidates was the so-called Copenhagen (membership) criteria which were drawn up by the European Assembly in 1993: politically, a new membership candidate has to have enough institutional stability to be able to guarantee a political system built on democratic principles and the rule of law, where human rights are observed and minorities are protected. Economically, the existence of a workable market economy, as well as the ability to withstand the competitive pressure and the market forces inside the Union, are prerequisites.

Beyond that, the membership candidates have to be able to take on the commitments arising from their membership in the form of the *acquis communautaire*, which comprises all valid contracts and legal acts, and to adopt the aims of the political union and of the economic and monetary union. The legal regulations on the admission of a new member state can be found in Article 49 of the EU Treaty.

After hearing the Commission and after the European Parliament has given its approval, the Council makes a unanimous decision. The actual membership conditions, the required periods of



transition and the amendments to the Community treaties that new membership necessitates, are regulated through an agreement between the existing member states and the candidate state, and must be ratified by all states which are party to the Treaty.

In the course of 2002, negotiations on each of the 31 chapters of the *acquis communautaire* came to a positive conclusion for 10 out of a total of 13 membership applicants, with only Bulgaria, Romania and Turkey being left out. In many cases, special regulations had to be put in place aimed at facilitating the transition of new member states not financially able to implement all the EU regulations immediately. But even

existing member states, especially the border countries Germany and Austria, benefited from transition periods extending to several years, particularly where freedom of domicile was concerned.

In December 2002 the European Council in Copenhagen was able to officially conclude membership negotiations with these 10 countries – just less than nine years after the ‘Copenhagen Membership Criteria’ had been formulated. After the existing member states, the citizens of the new member states and the European Parliament had given their agreement, the membership treaties for the 10 new EU members were signed in Athens. On 1 May 2004

they joined the EU as new member states. While Bulgaria and Romania joined the EU at the beginning of 2007, no date has been set yet for Turkey. The same goes for Albania, Bosnia-Herzegovina, Croatia, Macedonia and Serbia-Montenegro, countries which have already received signals from the EU that they may one day become eligible for membership.

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## EU: Environmental policy

Market competition for goods is an important principle of the  $\rightarrow$ social market economy. In the course of political  $\rightarrow$ integration in Europe, it follows that the protection of competition does not halt at the borders of the European Union (EU) member states, rather it applies to the entire EU market:

- Environmentally relevant product regulations of the member states should not lead to the obstruction of trade, either wanted or unwanted (protectionism). In practice, harmonised minimum standards are agreed in advance according to Article 96 of the EC Treaty.
- Regarding environmental protection, member states of the EU could allow aid that would distort  $\rightarrow$ competition in

the EU common market. Thus, national environmental protection subsidies are subject to EU monitoring according to Article 87 of the EC Treaty.

The EU justifies the many guidelines and regulations with the argument that similar environmental standards for the production of goods should exist in all member states of the EU. These are intended to guarantee that supply prices within the common market do not differ based on varying environmental costs.

However, why should cost factor differences be allowed in all other areas but none in regard to the environmental factor ( $\rightarrow$ environment-oriented management)? Furthermore, the expense costs can be different between the member states, while some regions may be more heavily strained making more stringent production standards necessary.

Essentially, environmental protection is an input factor that is in varying demand and is being supplied according to changing priorities based on income differences. The advantages of national production standards are set against the danger of environmental dumping. Accordingly, lax national environmental standards would be put in place to attract capital and mobile  $\rightarrow$ enterprises to certain locations.

In democracies, location competition is not solely accomplished at the expense of the environment, which means that economic growth and employment are not given preferential treatment over the protection of the environment. Environmental quality is the key factor for enterprises in relation to environmental infrastructural facili-



ties and the selection of personnel. Environmental pollution is a loss of welfare for the citizens. Thus, the political process weighs the concrete advantages against the tangible disadvantages.

The varying environmental qualities of the member states arise from differing preferences, costs,  $\rightarrow$ income, etc. As long as the costs and advantages of environmental policy are concentrated within the member states and follow the democratically created political regulations, decisions regarding the manner in which national environmental problems are to be dealt with and enforced can be bestowed on the member states. These circumstances do not mean that the applicable EU regulations regarding national environmental policy cannot be enforced; however, they do mean that implementation is tied to the voluntary adoption on the part of the member states.

The polluter-pays principle outlined in the Treaty of the European Union can be traced back to common preferences; at the same time, this principle also allows for meaningful solutions to national environmental issues. These procedures – from the perspective of the politics of social market economy – are to be actively implemented as they are based on the general regulations and the decentralisation of political competences, as well as the principle of subsidiarity.

This is also valid when transnational environmental issues arise. Regardless of the degree of the political integration process, a coordinated  $\rightarrow$ environmental policy is advantageous in a situation such as this – by contrast with national environmental problems. With transnational pollution, e.g. through emissions into

the air or water, the emitting nation is to cover the costs of the environmental pollution. At first glance, the emitting nation would not appear to have an incentive to consider the profit to the investment in the environment outside national borders. As the other member states are in a position to profit from the improved environmental quality without participating in cost sharing, the environmental pollution of the emitting source is outweighed.

A framework designed to deal with this dilemma and the national as well as extra-territorial advantages (costs) of environmental investment is required. The larger the group of affected member states (e.g. large-scale air pollution), the more meaningful it is to coordinate activities at the EU level; otherwise, the affected countries can reach an agreement on their own. These negotiations can be executed more effectively and lead to conflict resolution if there is an institutionalised order element like the polluter-pays principle. Here, again, a rule corresponding to the social market economy is the key factor for the protection of the environment.

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## EU: History

The beginnings of the European Union (EU) dates back to 1952 when the European Community for Coal and Steel (ECCS) was founded. The otherwise standard contract under international law, to which six member states were parties, stood out in that common institutions were established (High Authority Commission; Parliamentary Assembly, later: European Parliament; Council of Ministers; Court of Justice), which were authorised to act on behalf of the Community.

Initially, industries important for military purposes had been successfully dealt with on a Community basis in the context of the ECCS, but the next step was to create a European defence community, complete with a European army. This plan failed in 1954, together with the attempt to bundle the steps towards →*integration* which had been taken so far, in a European political community. The indirect consequence was the expansion of the Brussels Pact (1948) on the Western European Union, which had come into force in 1955. This organisation, which had not been part of the common contractual agreement, gradually started to be introduced almost completely into the legal stock of the European Union.

The first comprehensive political attempt at integration did not succeed. This prompted the decision among the founder states to continue pursuing the route of economic integration. After coal and steel (ECCS), further sectors were integrated (1958 European Economic Community [EEC]; agriculture and customs system; EAC: nuclear energy community). It was hoped that

the experience gained during the close cooperation in the economic field would have a ripple effect on the more sensitive political areas.

The speedy implementation of important stages of the Treaty of Rome (as the EEC and the EAC treaties were also called) led to a renewed attempt to pursue the goal of a European political union that would have gone beyond mere economic integration (Fouchet plans 1960/62). But this time, also, the attempt to give the steps towards integration a common political denominator failed.

Less spectacular progress was made with the Own Resources System of the EEC (1971); the European Parliament and the Council's joint responsibility for the EC budget (1975); and the first direct elections of the European Parliament (1979). Nonetheless, the supra-national efforts of the integration were stagnating. During the 1970s, reform plans were defeated by the growing weight of the member states inside the EEC and by the diminishing external pressure on Western integration, brought about by the policy of *détente* directed towards Eastern Europe.

Under these circumstances, the integration process became more focused on political fields outside the confines of the Treaty of Rome, and harking back to traditional methods of intergovernmental cooperation: Regular communication on foreign policy from 1970 (European Policy Cooperation [EPC]; 1972 Currency Snake, 1979 European Currency System (ECS); 1974 regular meetings of the heads of state and governments of the EEC member states (European Council).

The first reform of the Treaty of Rome by the Uniform European Act that followed was a step in the right direction after this ‘intergovernmental phase’ of European integration (1987). Key elements were the ‘second attempt’ to have completed the establishment of a European domestic market no later than 31 December 1992, as well as the integration of the EPC and the European Council into the Community treaties.

The 1990s saw one treaty reform after another: the Treaty of Maastricht (1992) saw the legal incorporation of the →*European Economic and Monetary Union* into the EC Treaty and at the same time the firm establishment, at a European level, of important elements of the →*social market economy* in the EU, such as the foundation of an independent central bank.

The contract was given its already distinctive temple structure: the ‘Treaty on the European Union’ is held up by three columns (European Community – EC; Common Foreign and Security Policy – CFSP; cooperation in the areas of Justice and the Interior – CJI), each of which is important for the process of integration in a different way.

The EEC Treaty gradually grew into the ‘Treaty on the Foundation of a European Community’ (EC), which was supposed to give expression to the increased importance of political issue in the EU.

Through the Treaty of Amsterdam (1998), among other things, a space was created for security, freedom and the law as an (internal) equivalent to the (economic) domestic market and (external) Common Foreign and Security Policy. The Treaty of Nice (2000), on the other

hand, was an attempt to achieve an adequate integration of the institutional apparatus into the EU that, on the eve of the largest round of expansion talks in its history, counted 15 member states. During the summit in Nice, the heads of state and government adopted the Human Rights Charter of the EU (including a chapter on ‘Solidarity’). The statement on the future of the EU, which was also adopted, formed the basis for the convention called to work out a constitutional EU Treaty making the contents, structures and procedures of the EU more transparent, more democratic and more efficient.

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Melanie Piepenschneider

### **EU: Industrial, research and technology policy**

The Unified European Act (1987) and the Treaty of Maastricht (1992) significantly increased the competence of the European Union (EU) in the field of research and technology policy. In Article 130, a group of objectives for industrial policy was agreed for the first time at EU level. This was subsequently expanded in the Treaty of Amsterdam. Article 163, section 1, reads:

‘The Community aims to strengthen the foundation of the EU’s industri-

al sector through science and technology while promoting its ability to compete internationally. It aims to lend its support to all research projects which other sections of this treaty may deem necessary.'

In order to enhance its international competitive advantage, the Community has to identify key areas in industry. This means it is implementing 'design policies' (W. A. Jöhr) in the field of industrial economy. In this respect, the industrial, research and technology policy of the EU can be interpreted as →*industrial policy*, oriented along the lines of technical progress or focused on economic innovation.

In order to achieve its goals, the EU promotes cooperation between →*enterprises*, research centres and universities across the national borders of its member states. In addition, it supports the transfer of research outcomes and the mobility of scientists.

These measures are implemented in four different ways:

- Indirect actions are the most important, receiving about 75% of the available funding. In this case, one is dealing with research projects that are carried out by companies and scientific institutions, with the EU covering a maximum of 50% of the costs.
- Direct actions are reflected in the research carried out by the EU itself in the Community research institutions and in the common enterprise Joint European Torus.
- →*Concerted Actions* are the attempt by the EU to coordinate research and development activities; the financial

funding, however, is limited to the costs of administration.

- Horizontal actions have grown in importance over the past number of years. These offer opportunities for scientists to meet and exchange their research results, while also forming the basis for an efficient spill-over to the other categories of the programme, especially the indirect actions. In this case, the EU funding can be as high as 100%.

The EU's industrial, research and technology policy can be divided into four phases of development:

- The first phase (1951–1973) was mainly concerned with the construction of Community policies and research – limited to the sector of nuclear power and related technology.
- Expanding competences in the area of industrial, research and technology policy was the theme of the second phase (1974–1980). It was characterised by a greater focus on a more active Community role.
- Characteristics of phase three (1981–1987) were the development of a proactive industrial policy and the reorientation of the industrial, research and technology policy.
- Phase four began in 1987 with the theme 'Europe on the way to becoming a technological Community'.

This fourth phase is marked by more tangible action and greater emphasis on industrial, research and

technology policy within each of the framework programmes. The fourth framework programme (1994–1998) was already put together along the lines of this new orientation. Its main focal point was information and industrial as well as energy technology.

Eight task teams (work units run by experts) were set up with the aim to contribute to the construction of a global information society. They serve as coordinators and packagers of industrial, research and technology policy activities in Europe, and deal with topics with an impact on the future, such as the ‘multi-media learning programme’. The task teams are supposed to help the market maturation of technologies. As this method is controversial from the perspective of institutional order policy, one wonders how seriously the Commission takes the definition of ‘pre-competitive’ research.

The fifth framework (1998–2002) introduced a new concept, restricting the research effort to those areas which yield tangible benefits for the common person, especially in terms of →*employment*, quality of life, and technologies that are able to compete internationally. The restriction to a limited number of themes, such as ‘quality of life and management of living resources’ or ‘competition-oriented and sustainable growth’ increases the effectiveness of the respective measures. A further innovation concerns the criteria that are applied in the project selection. Out of a list of criteria, social needs, economic development as well as perspectives of science and technology have been selected for their specific relevance.

In January 2000, the EU Commission stated that despite the Community

framework programmes there is no such thing as a joint European industrial, research and technology policy. Its critique implies that the research policies of the individual member states and of the EU itself are often running parallel, meaning that both bodies are active in the same fields. The phenomenon of double research is hereby addressed – which the Commission sees as a waste of resources.

From the point of view of competition policy, however, double research is not to be absolutely rejected. The more mature concept will win at the end of the development process. Moreover, the time that a new technology takes to be developed is markedly shorter, since the research teams are motivated by the desire to be the first to present their results.

The sixth framework programme (2002–2006) marks the start of phase five, entitled ‘Research in Europe’. The goals set by the European heads of state and government at the European Council in Lisbon (March 2000) included the transformation of the EU into the world’s most competitive and most dynamic knowledge-based economy, capable of achieving continued growth, full employment and more social cohesion by 2010. With this in mind, the EU is eager to provide more funds for the promotion of scientific excellence, both in the EU member states themselves and in the rest of Europe. It is planned to step up the proportional expenditure for research and technical development from 1.9% (2000) of GDP to almost 3%, with private sector contributions towards research and development expenditure expected to rise from 56% to 66%. To

make this a reality, the EU provides a budget of €16.27 billion. Its involvement is focused on those areas of research which promise the greatest added value for Europe. The EU has recognised the need to create a critical mass of financial and human resources and to pool the complementary skills available in the different countries, thereby making Europe a better place for research.

The connection between the priorities and interests of the EU and the transnational nature of research is also important. The simplification and streamlining of the procedural rules are meant to enable small and medium-sized enterprises (SMEs) to gain easier access to the available resources of the EU. The difficult and complex application procedures of the past ensured that SMEs used to be largely excluded. But for the new framework programme, the EU will also change its funding methods. From now on, the plan is to have three main instruments: networks of excellence; integrated projects; and EU participation in programmes which, on the basis of Article 169 of the EC Treaty, are carried out in collaboration with other countries.

The latter instrument is different from the other two because the initiative and the main emphasis come from the EU. This is expected to encourage more top-class achievements in the field of European science and technology. The continuing concentration of scientific talent which exists in the various European regions is supposed to guarantee this. The EU gives financial support to the integration with a wide range of flexibility within the research net.

The integrated projects in particular

represent a departure by the EU from the sphere of basic research, since this instrument has been conceived specifically with tangible outcomes in mind. These might even include specific products or techniques. The integrated projects are supposed to be implemented by public-private partnerships.

The sixth framework programme was also conceived for the promotion of international cooperation and to accelerate European integration. For this purpose, for example, the funds for the promotion of the international mobility of scientists have been increased. Whether the industrial, research and technology policy will be equal to this task remains, however, to be seen.

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#### EU: Maxims for action

The economic policy of the European Union (EU) comprises – as in the case

of the economic policy of the member states – the establishment of legal norms that govern private and state-owned economic agents (→*institutional order policy*) and the state influences on the economic activity (→*process policy*).

The EU is a multilevel system that comprises the levels of the European Community (EC), the member states, the countries or provinces, districts and municipalities. In the first place, the appropriate level for certain policy areas or objectives needs to be decided on a case-by-case basis. Second, the type and intensity of collaboration between the EU and the member states needs to be decided.

Regarding the first question, the Maastricht Treaty of 1992 anchored the subsidiarity principle in the EC Treaty. This was in part a reaction on behalf of state and government heads to the prediction expressed by Commission President Delors to the European Parliament (6 July 1988) that in 10 years, 80% of the economic legislation – and perhaps also the tax and social legislation – will be of EU origin. According to the principle of subsidiarity, the Community becomes active in areas that do not fall within its exclusive competence only ‘in so far as the objectives of the proposed action cannot be sufficiently achieved by the member states and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community’ (Article 5, EU Treaty – new).

Ideally, regulations and instruments are to be reached on a decentralised basis, at the level of the member states or regions and only in instances where a central (European) regulation is convenient or where the EU is explicitly

responsible should the Community become involved.

This allocation of responsibilities is in principle correct. However, some situations are vague and the allocation of responsibilities is at the discretion of the Community. This means that consideration must be given to the uniform or harmonised legislation and policies of the European Common Market (decrease in transaction costs for →*enterprises* and consumers), the economic costs, the second- and third-best solutions arising from a common agreement and the advantages of →*competition* between the different national concepts (educational effects).

Some policies are either wholly or comprehensively ‘communitarised’, i.e. national decision-making powers have been withdrawn (e.g. →*EU: trade policy*, →*EU: agricultural policy*, →*European monetary policy*, market access for citizens of the EU, enterprises, free trade of goods and services) and others are subject to common minimum standards as well as other limitations (e.g. valued-added taxes and excise duties, subsidies, technical norms, consumer protection, environmental standards). On the other hand, member states continue to be free to design important local conditions (labour market regulations, direct taxes, education system, infrastructure policy), social systems (→*pension insurance*, →*health insurance*, →*unemployment insurance*) and the continual financial policy (amount and structure of the public revenue and government expenditure).

Regarding the second question, the collaboration between the EU and the member states sometimes requires ratification from the national parliaments

of the member states concerning legal frameworks (amendments to the EU and EC treaties) as well as on matters of EU membership. The concrete implementation of these legal parameters can be realised in many different ways.

With regard to setting medium-term binding legal norms, the Council (of Ministers) passes guidelines and regulations and makes decisions based on the recommendation of the European Commission, with varying involvement of the European Parliament. The Council's decisions must be made unanimously or according to majority vote. This is also true for the realisation of the five fundamental rights (free trade of goods, services and capital, personal free domiciliation, freedom for enterprises to establish businesses), the entire area of the Common Market (product- and market-related regulations) as well as the EC budget.

Individual measures, recommendations and positions are made by the Council (e.g. intervention prices in agricultural policy, commercial policy protection measures, economic stabilisation policy recommendations) or by the Commission (e.g. competition and subsidy monitoring, initiation of breach of treaty proceedings, research subsidies) or, with regard to monetary policy, by the European Central Bank.

The Council is both a legislative and executive body. It shares responsibility for legislation with the European Parliament, and shares the tasks of governing and administering with the Commission. The function of representing interests of the member states requires a procedure that strives for consensus. This leads to lengthy delays in

the decision-making process, to agreements based on common ground and to the linking of diverse subject areas in negotiation packages. The Community interests are represented by the Commission, the European Parliament and the European Court of Justice.

The Commission monopolises proposals in that the Council can become active only when a proposal from the Commission has been presented. However, the proposal has usually been clarified with national bodies in order to increase its chances for success (→EU: *organs and institutions*).

The collaboration between the national and European political and administrative structures, as well as the functions and competences of economic policy in the EU system, would appear to be highly complex and confusing; yet at the same time this system is anything but static and it is defined by dynamic transition.

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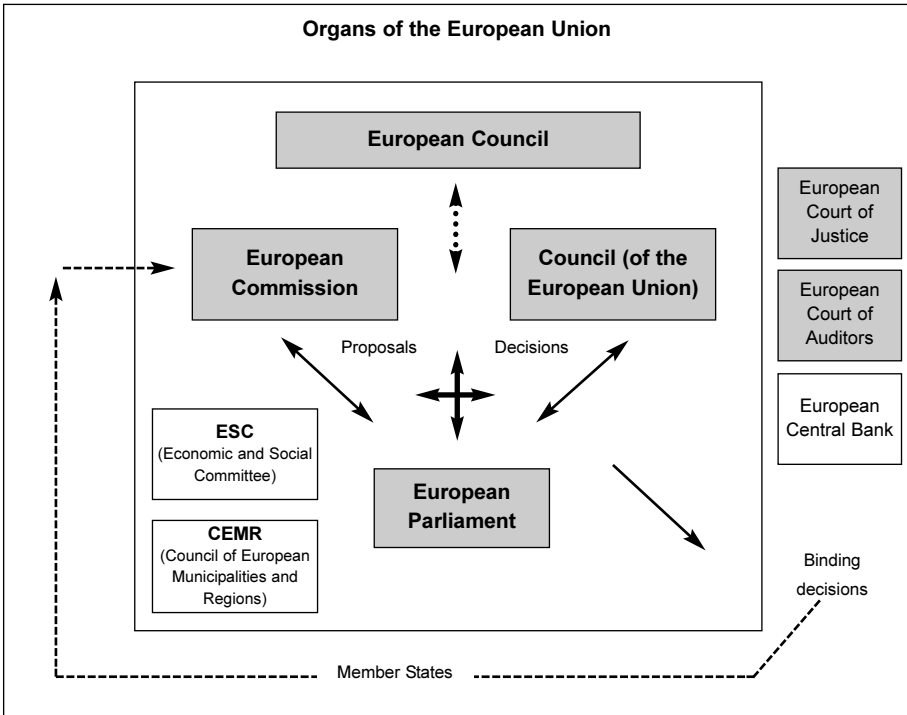
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### EU: Organs and institutions

As they are moving towards an 'increasingly close-knit union of the peoples of Europe' (Article 1 European Union Treaty [EU-T]), the institutions of the European Union are becoming the ulti-





mate decision-making powers in a growing number of political fields.

Notwithstanding the ‘unified institutional framework’ (Article 3 EU-T) of the EU, the preparation, creation, implementation and control of legal acts through the European institutions are still dependent upon their respective political field, and therefore subject to varying degrees of political participation and involvement in each of the different ‘columns/pillars’.

Besides the predominantly supranational character of the first column, which is about the European communities and the EU domestic market, the wording of the treaties also embraces the second pillar, which is equipped with inter-governmental powers relating to joint external and security policies, as well as the third pillar with its equally international features for the

police and judicial cooperation in criminal matters.

In the first column, the key competences at the European level have been distributed among five institutions – the European Commission, European Parliament (EP), Council of the EU, European Court of Justice (EuCJ) and European Council. At the same time, the European Auditor General (EuAG), the Council of European Municipalities and Regions (CEMR) and the Economic and Social Committee (ESC) also play a decisive role in the institutional structure. Other important organs are the European Central Bank (ECB), the European Investment Bank (EIB) and the ombudsman.

The *European Commission* (Articles 213-219 EC-T) is the executive and administrative organ of the EU with its headquarters in Brussels. The adminis-

tration consists of about 16,000 civil servants in 23 head offices and other offices. Due to its exclusive right to propose legislation, the Commission – which is not subject to national government directives but takes decisions as a cooperative organ – plays a key role in the first column during the phase leading up to a vote. As a ‘motor of integration’, it identifies problems, draws up agendas and formulates draft proposals for votes. Beyond that, in its capacity as ‘executive’, it takes, as far as it is authorised, binding executive decisions, guarantees the proper functioning of the common market, is in charge of the Community budget and negotiates international agreements. In its capacity as ‘guardian of treaties’, the Commission supervises and monitors the application and observation of the Community law.

The **Council (of the European Union)** (also known as the Council of Ministers) (Articles 202–210 EC-T) is the key legislative organ of the EU, which, however, has begun to share its legislative and budgetary role increasingly with the European Parliament. It consists of one (expert) minister per member state and convenes – depending on the subject under discussion – with varying contingents of members present, and is chaired by the presidency which rotates at six-monthly intervals.

The Council is based in Brussels and has its work prepared for it by its General Secretariat and by the Committee of Permanent Representatives (CPR), which meets every week. The Council’s internal voting procedures vary depending on the policy field. Basically, there are unanimous votes and votes requiring a simple or a

qualified majority. In the case of qualified majority votes, the votes in the Council of Ministers are weighed according to the population size of the member states.

The **European Council**, which consists of the heads of state and government of the member states, as well as the president of the European Commission – supported by their ministers of foreign affairs and by other members of the European Commission – occupies a special position within the institutional structure of the EU.

In its capacity as ‘architect of the constitution’, the European Council has been deeply involved in the practical development and organisation of European treaties since 1974. The European Council meets four times a year and serves – despite not officially being an organ of the EC – as the highest and final decision-making body. As ‘setter of guidelines’, it serves especially in the fields of economic policy and the joint external and security policies and in its capacity as the ‘highest organ of appeal’ for controversial issues in the common policy areas.

The **European Parliament** (Articles 189–201 EC-T) in Strasbourg is the only EU organ whose members are elected directly by the citizens of the member states. The EP has controlling rights over both the Commission and the Council, is involved in the appointment of the European Commission, has budgetary rights and participates (again depending upon the political field) in the legislative process of the Community. But its greatest potential influence relates to the co-decision procedure, where it occupies the role of a second chamber.

The 732 EP parliamentarians (Treaty of Nice) whose appointment lasts for one five-year legislative period, and each of whom belongs to an organised political party, reflect the diversity of the European political landscape. In the sixth electoral period of the EP, two-thirds of all delegates belonged to the European Peoples' Party with its Christian Democratic outlook and to the Party of European Socialists.

The *European Court of Justice* (Articles 220-245 EC-T) in Luxembourg consists of one judge per member state. The judges are unanimously appointed by governments of the member states for a six-year period.

In its capacity as the highest Court of Appeal for all legal issues in the EU, the EuCJ, assisted by attorneys general, deals with law suits instituted by member states or EU organs, disputes between governments of member states and EU institutions, as well as internal conflicts in the EU.

The courts of the member states have to refer cases which concern EU law to the EuCJ, which then through its decisions creates precedents for the interpretation of European Law, and which thus guarantees the consistent interpretation and application of Community Law.

The *European Auditor General* (Articles 246-248 EC-T) with headquarters in Luxembourg, is responsible for the lawful and proper handling of the income and expenditure of the EU. Its members, which are appointed for six years (one representative per member state), draw up the annual report and issue special reports and statements with which they monitor the finances of the EU, and which demonstrate the

budgetary efficiency of the various organs.

The *Council of European Municipalities and Regions* (Articles 263-265 EC-T) and the *Economic and Social Committee* (Articles 257-262), which are made up of 350 representatives of the regional and municipal administrative authorities, and 350 representatives of economic or social lobbies respectively, give the Community two advisory bodies that have to be given compulsory hearings on specific political subjects, but whose statements have no binding consequences for the legislative process.

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### **EU: Reforms and consolidation – economic aspects**

Since its establishment in 1958, the European Economic Community (EEC) has been attracting new members (→EU: enlargement). At the same time, the member countries have transferred more and more tasks to the common European institutions. In this way, the EEC has grown from six founder members to a European Union (EU) embracing 27 countries with a common

**Chronological listing of expansions and of membership applications in the EU,  
1961–May 2007**

	<i>Application</i>	<i>Response from the Commission</i>	<i>Start of negotiations</i>	<i>End of negotiations</i>	<i>Membership</i>
Great Britain	09.09.1961		08.11.1961	29.01.1963	
	10.05.1967	29.09.1967	30.06.1970	22.01.1972	01.01.1973
Denmark	10.08.1961				
	11.05.1967	29.09.1967	20.06.1970	22.01.1972	01.01.1973
Ireland	31.07.1961				
	11.05.1967	29.09.1967	20.06.1970	22.01.1972	01.01.1973
Norway	30.04.1963				
	21.07.1967	29.09.1967	30.06.1970	22.01.1972	–
Greece	12.06.1975	29.01.1976	27.07.1976	28.05.1979	01.01.1981
Portugal	28.03.1977	19.05.1978	17.10.1978	12.06.1985	01.01.1986
Spain	28.07.1977	29.11.1978	05.02.1979	12.06.1985	01.01.1986
Turkey	14.04.1987	14.12.1989	03.10.2005		
		13.10.1999			
Austria	17.07.1989	01.08.1991	01.02.1993	12.04.1994	01.01.1995
Sweden	01.07.1991	31.07.1992	01.02.1993	12.04.1994	01.01.1995
Finland	18.03.1992	01.11.1992	01.02.1993	12.04.1994	01.01.1995
Norway	25.11.1992	24.03.1993	05.04.1993	12.04.1994	–
Switzerland	26.05.1992				
Cyprus	04.07.1990	30.06.1993	30.03.1998	13.12.2002	01.05.2004
Hungary	31.03.1994	16.07.1997	30.03.1998	13.12.2002	01.05.2004
Poland	05.04.1994	16.07.1997	30.03.1998	13.12.2002	01.05.2004
Estonia	24.11.1995	16.07.1997	30.03.1998	13.12.2002	01.05.2004
Czech. Rep.	17.01.1996	16.07.1997	30.03.1998	13.12.2002	01.05.2004
Slovenia	10.06.1996	16.07.1997	30.03.1998	13.12.2002	01.05.2004
Malta	16.07.1990	30.06.1993	15.02.2000	13.12.2002	01.05.2004
Slovakia	22.06.1995	13.10.1999	15.02.2000	13.12.2002	01.05.2004
Latvia	13.10.1995	13.10.1999	15.02.2000	13.12.2002	01.05.2004
Lithuania	08.12.1995	13.10.1999	15.02.2000	13.12.2002	01.05.2004
Bulgaria	14.12.1995	13.10.1999	15.02.2000	15.06.2004	01.01.2007
Romania	22.06.1995	15.06.1997	15.02.2000	25.05.2005	01.01.2007
Croatia	21.02.2003	20.04.2004	04.10.2005		
Macedonia	22.03.2004	17.12.2005			

*Source: Piazzolo, D. (2001), The Integration Process between Eastern and Western Europe, Kieler Studien 310, Berlin; and supplemented by editors.*

domestic market, a common currency (→*European Economic and Monetary Union*) and a common political process. Beyond that, additional countries have applied for membership (*see table*).

During the 1999 Helsinki convention of the European Council, Turkey was granted special candidate status, while membership negotiations have to be initiated on the basis of a Commission report submitted to the European Council. In the referendums of 1972 and 1994, Norway rejected the membership conditions, and in 1992, Switzerland suspended its membership application.

The large number of membership applications reflects the economic attractiveness of the EU. The common domestic market, which guarantees the freedom of movement of persons, capital, goods and services as well as the freedom to establish an →*enterprise*, makes the efficient allocation of the factors of production and effective →*competition* possible within the EU. That contributes to increased prosperity in all member states.

But the associated structural changes demand adjustment in the sectors and areas concerned. In industries that are no longer competitive this can lead to job losses, while in growing industries jobs will be created. The movement of the factors of production, labour and capital, favours a balanced labour market and a higher European economic output. The mass migration of labour towards the Southern enlargement (Greece, Spain and Portugal) which had been predicted in some quarters did not occur, nor is it expected to occur even after the Eastern enlargement of the EU. Transfer pay-

ments by the EU to the poorer member countries in the context of the structural funds (→*EU: regional and structural policy*) are intended to stimulate growth in these countries and to accelerate the equalisation of standards of living within the EU.

A uniform set of rules was created, which is binding for all member states. This so-called *acquis communautaire* covers:

- the content, principles and political goals of the treaties (including the treaties of Maastricht of 1992, Amsterdam of 1997 and Nice of 2000);
- the legislation arising from the treaties and the jurisdiction of the European Court of Justice;
- the accepted statements and resolutions within the context of the EU;
- the positions, explanations and decisions in the context of the shared foreign and security policies;
- the positions, decisions and accepted conventions in the context of the shared legal and domestic policies; and
- the international agreements of the EU, as well as the agreements between the member states, which were made with reference to special EU activities.

Despite the *acquis communautaire*'s daunting 80,000 pages, all new member countries have to adopt the entire set of rules, so that the same rights and obligations apply to all member countries. Therefore, generally no digressions are

allowed; however, in particularly difficult areas, transition periods can be granted to new member countries (environmental policy, agricultural policy, hygiene standards, the freedom to establish a business and the right to own land). But even long-standing members require transition periods, e.g. regarding the freedom of movement for workers (Germany and Austria: 7 years).

Since certain aspects, rules and standards of the *acquis communautaire* do not correspond to the level of development of the new member countries and also of some of the poorer EU member countries, substantial costs and distortions result from the implementation (e.g. from environmental protection measures).

This issue of the compatibility of an expanding EU (with countries with increasingly dissimilar economic power) and EU consolidation (deepening) (since some countries support more incisive shared regulations) requires reforms that go beyond the resolutions of the Nice Treaty of December 2000. The plan is to grant an extended EU sub-group of member countries the right to push the →*integration* between the member countries of this group forward without automatically expanding the *acquis communautaire* in the process.

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Daniel Piazolo

### EU: Reforms and consolidation – political aspects

As a result of the considerable dynamics of the European process of integration, the communal framework – originally developed in 1952 and then in 1958 for six founder states and a very limited number of political spheres – was subject to multiple changes. With the Single European Act (1987), and the treaties of Maastricht and Amsterdam regarding the European Union (1993 and 1999) as well as the Treaty of Nice (2003), the original treaty system has been comprehensively supplemented and adjusted.

The European Community developed from a customs union to a domestic market. Since the Maastricht Treaty, the organs and committees of the Union occupy themselves (according to various different procedures, it is true) with modern fields of political activity, such as environmental and consumer protection, as well as nearly all traditional responsibilities of the state, i.e. internal and external security. The regulation range and density of the Community has likewise clearly increased.

But since the expansion of the political spheres and responsibility allocations referred to above did not go hand in hand with adequate reform of the Community organs, as envisaged in the Treaty of Rome (1958), the EU – particularly in view of the planned enlarge-

ment rounds regarding the Southern, Central and Eastern European states – is faced with considerable challenges. In order to give the union more depth and to achieve the ‘implementation of an ever closer union of the peoples of Europe’ (Article 1 of the EU Treaty), the Community felt the need – besides the reform of political fields of central importance (agricultural and structural policy) – to also investigate the functioning of the institutions (size and composition of the Commission, balance of votes in the Council, greater number of ballots with a qualified majority).

The European Council in Berlin, with its Agenda 2000 which was adopted in March 1999, had already introduced the reform of the Community’s →*agricultural policy* as well as measures for economic and political cohesion. This was followed by the summit ending in December 2000 and the Treaty of Nice, which aimed at creating the foundation for institutional reforms.

One of the main points of the reform process of Nice was the new weighting of Council votes. Since with a view to future enlargement rounds the less populated member states would be at an advantage in relation to the larger states, at worst decisions could have been taken with a qualified majority which would not even have had the support of the simple majority of the entire population. Added to that was the threat of a strong distortion of the population weightings of individual member states. For this reason, in Nice, the votes were more spread out, now ranging from 29 (Germany) to 3 (Malta).

Three hurdles are envisaged. This means that for a legal act, in addition to

a qualified majority and a simple majority of the member states – on separate request – still another quorum of 62% of the EU population is necessary (depending on the number of member states approximately 71% to 74% of the votes). With this reform step the future hurdle for majority decisions is made more difficult, since in a union which has expanded to 27 member states neither the initial 15 EU members nor later on the 13 biggest or 22 smallest form a sufficient majority.

In contrast to the weighting in the Council, the redistribution of seats in Parliament orients itself more strongly guided by demographic standards. Germany, representing about 17% of the population in a 27-member EU, would achieve a proportion of 13.5% of the seats with a fixed number of 99 votes.

Considering the approximately 70 Articles of the Community treaties which are subject to unanimity, the expansion of majority decisions was also one of the quintessential points of institutional reform. It has to be prevented, that in an enlarged Union with up to 27 member states the unanimity requirement in the Council leads to a stalemate within the EU. With the Treaty of Nice the sphere of majority decisions was extended by a further 28 points, but important political aspects which are dealt with at a European level, for instance fiscal policy, are invariably subject to the unanimity requirement.

Bearing in mind the sobering outcome of Nice versus the positive experiences derived from the Basic Rights Convention, the idea was promoted that in order to achieve a more far-reaching

**Vote distribution in the EU Council and the EU Parliament (EP) in terms of the Treaty of Nice**

<i>Member state</i>	<i>Population in millions</i>	<i>EU-27 population in %</i>	<i>Council votes<sup>1</sup></i>	<i>EU-27 Council in %</i>	<i>EP seats<sup>2</sup></i>	<i>EU-27 EP in %</i>
Germany	82,5	17.02	29	8.41	99	13.52
France	59,8	12.33	29	8.41	72	9.84
Great Britain	59,2	12.21	29	8.41	72	9.84
Italy	57,6	11.88	29	8.41	72	9.84
Spain	41,9	8.64	27	7.83	50	6.83
Poland	38,2	7.88	27	7.83	50	6.83
The Netherlands	16,2	3.34	13	3.77	25	3.42
Greece	11,0	2.27	12	3.48	22	3.01
Portugal	10,4	2.15	12	3.48	22	3.01
Belgium	10,4	2.15	12	3.48	22	3.01
Czech Republic	10,2	2.10	12	3.48	20	2.73
Hungary	10,1	2.08	12	3.48	20	2.73
Sweden	9,0	1.86	10	2.90	18	2.46
Austria	8,1	1.67	10	2.90	17	2.32
Denmark	5,4	1.11	7	2.03	13	1.78
Slovakia	5,4	1.11	7	2.03	13	1.78
Finland	5,2	1.07	7	2.03	13	1.78
Ireland	4,0	0.83	7	2.03	12	1.64
Lithuania	3,5	0.72	7	2.03	12	1.64
Latvia	2,3	0.47	4	1.16	8	1.09
Slovenia	2,0	0.41	4	1.16	7	0.96
Estonia	1,4	0.29	4	1.16	6	0.82
Cyprus	0,7	0.14	4	1.16	6	0.82
Luxembourg	0,4	0.08	4	1.16	6	0.82
Malta	0,4	0.08	3	0.87	5	0.68
<b>Total EU-25</b>	<b>455,3</b>		<b>321</b>		<b>(682)<sup>2</sup></b>	
Romania	21,7	4.48	14	4.06	33	4.51
Bulgaria	7,8	1.61	10	2.90	17	2.32
<b>Total<sup>3</sup> EU-27</b>	<b>484,8</b>	<b>99.98</b>	<b>345</b>	<b>100.05</b>	<b>732</b>	<b>100.03</b>

Source: Eurostat, European Parliament.

1 The vote distribution in the Council only came into force on 1 November 2004. Between 1 May and 31 October 2004, interim arrangements applied.

2 This distribution of seats was originally supposed to become effective after the European Parliamentary Elections in 2004. Since Bulgaria and Romania join the EU in 2007 at the earliest, the seats reserved for them were equally distributed among the other member states, so that the European Parliament already had the maximum number of 732 members.

3 Deviation from 100% due to rounding off.



EU reform, a convention, meeting publicly, should be formed. Between February 2002 and June 2003, based on the Laeken Declaration and chaired by President Valéry Giscard d'Estaing, a committee of 105 delegates convened which was made up of representatives from all the existing and prospective member states, the EU institutions and the national parliaments. It was their intention, as an alternative to a heads of state or government conference, to come up with an answer to the 'critical questions' concerning the 'future development of the Union'.

The convention ratified a draft 'Agreement on a European Constitution', offering numerous options which could improve the union's institutions' ability to act. Reform proposals were submitted, particularly on the subjects of defining the competencies of the different levels (EU, member states, federal states/ regions, etc.), the role of the national parliaments in the integration process and the simplification of the treaties. Concerning the most crucial issue, which is the voting method in the Council of Ministers (Council of the EU), the convention advocated the double majority principle. This would mean that from 2009 onwards, the Council's qualified majority decisions would require both a majority vote from the member states (50%) as well as a majority vote from the EU population (60%).

However, since the December 2003 governments' conference could not agree on the double majority principle, the convention's draft comprehensive constitutional proposal also failed. But due to changed (party-) political affiliations among the EU member states, the

proposal was eventually accepted in the summer of 2004 when the European Council had an Irish president, and it was submitted to the member states for ratification. Ratification was denied by voters in France and the Netherlands. However, in 2007 new steps have been taken to deal with these matters in a governments' conference.

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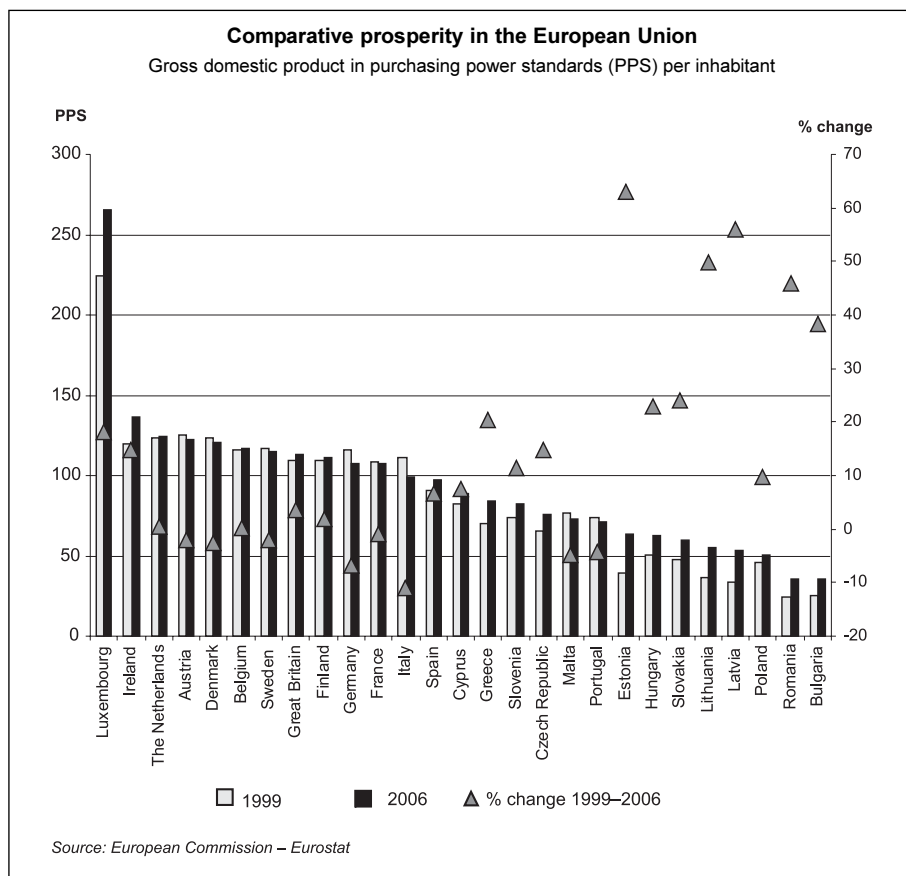
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## EU: Regional and structural policy

The →*European Union* is characterised by considerable internal economic and social differences. In 1998, the average per capita →*income* in the EU's poorest region (Ipeiros in Greece), was only 42% of the EU average, while the average income in the most affluent region (Central London) amounted to 243% of the EU average (*see figure, next page*). The income differential at national level among the member states is slightly less steep, but it nevertheless ranges from 66% in Greece to 176% in Luxembourg.

Differences in terms of →*unemployment* are also marked. In 1999, regional unemployment ratios ranged from 2.1% in the Aland Isles in Finland, to 28.7% in Calabria in Italy. The national unemployment ratios measured between 2.4% in Luxembourg and



16.1% in Spain. The reduction of these differences is the most frequently cited reason for the existence of European regional and structural policies (RSP).

The basic structure of the EU RSP was established in the late 1980s. At that time, especially the less affluent EU member states wanted to see the EU domestic market grow by making the economically backward regions of the EU more competitive. This is achieved above all through investment in the areas of infrastructure and human capital, as well as through encouraging private investment.

The direct redistribution of financial resources among the member states

along the lines of financial equalisation in Germany was politically impossible in the EU. This is why the EU designated different types of ‘problem regions’, which are developmentally assisted by the RSP. After some amendments were made to these so-called RSP ‘objectives’, they have been detailed as follows for the period of 2000–2006:

- *Objective 1:* Developmentally backward regions (defined as average per capita income of less than 75% of the EU average). These regions are inhabited by about 22% of the total EU population, especially in Greece,

Portugal, Spain, Italy and the former GDR. About 70% of the RSP budget is used for this objective.

- *Objective 2:* The regions which are particularly affected by economic and social changes (e.g. out-dated industrial regions and rural areas with downmarket economic development). About 18% of the EU population live in such regions and about 12% of total funds flow to Objective 2 regions, which is a significantly smaller per capita percentage than Objective 1 regions.
- *Objective 3:* Assistance with the adjustment and modernisation of the education, vocational training and employment policies and systems. This assistance, which adds up to 12% of the RSP total funds, may be granted to any region which is not classified as Objective 1. The detailed regional allocation of funds has largely been left up to the EU member countries themselves.

Beyond that, a number of quantitatively less significant measures have been put in place in the context of the EU RSP; for example, the promotion of cross-border cooperation. The total cost of the financial measures planned for 15 member countries for 2000–2006 had been estimated to be about €213 billion (at 1999 prices).

Since the early 1990s, the EU RSP has effectively supported the economic progress of at least some of the targeted regions. Compared with the EU average in the 1990s, the per capita income in Spain, Portugal and Ireland, for example, has increased markedly. On

the other hand, the RSP can only have a positive effect if basic economic conditions such as  $\rightarrow$ *price level stability* and an appropriate tax burden have already been put in place.

But it has to be noted that RSP funding tends to be spread too broadly, with the result that its effectiveness is reduced. The furthering of human capital, for example, in relatively prosperous EU regions through Objective 3 of the EU RSP is economically barely justifiable. In terms of the subsidiarity principle, the EU RSP is generally only supposed to be implemented when a member state is not able to solve its structural problems on its own.

From a political perspective, however, it is in the interest of the ‘rich’ member states to secure RSP funds for their own benefit through instruments like Objective 3.

Then there is the problem that the coordination between EU RSPs and other policy areas is often inadequate. This means that there is a risk that the concentration of national and European funds for research and development in the economically strongest regions in the EU will reinforce the very economic differences inside the EU which were described earlier ( $\rightarrow$ *EU: industrial, research and technology policy*).

In conclusion it can be stated that  $\rightarrow$ *EU enlargement* represents a considerable challenge for the RSP. Since the average per capita income of most of the new member countries lies markedly below average of the older members, the Eastern enlargement is leading to a significant increase in Objective 1 regions. This in turn will either necessitate a considerable increase of the funding set aside for

RSP in the budget, or a reduction of the assistance allocated to the current member states.

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*Reiner Martin*

## EU: Social policy

The European Community (EC) was originally established as an economic community and was understood to be a project through which the political integration of Europe could be achieved using economic means. In contrast, socio-political questions such as a Europe-wide adjustment of the social security systems have played only a subordinated role. The refusal to adopt comprehensive social harmonisation has led to the fact that the presence of the 'social dimension' of the Community can be seen only in specific regulations.

The socio-politically relevant European Community Law has its roots in the principles of equal treatment of males and females regarding pay (Article 119), as well as in the creation of employee freedom with regard to the area of social security (Article 51), which is anchored in the 1957 treaty establishing the European Economic Community.

Thus, economic reasons were decisive here as well. While equal pay was intended to counteract competition distortions, the social protection of migrant workers formed a significant prerequisite for the free exchange of goods, labour, services and capital in the sense of the 'four basic liberties'. Both principles commonly attempt to counteract possible discrimination based on nationality and/or gender.

In particular, numerous decisions of the European Court of Justice illustrate that the non-discrimination principle enjoys a broad legal interpretation with high practice-oriented relevance, particularly since an individual member of a European Union (EU) member state is able to bring charges of discrimination. With the Single European Act of 1987, the protection of workers' health and safety (Article 118a, now Article 137 EC Treaty) has become a third column of Community → *social policy*.

Since then, Community-wide regulations that outline the minimum provisions for the organisation of working conditions with regard to the protection of the safety and health of the employees can be issued. In contrast, the regulation regarding the 'harmonisation of social systems' postulated in Article 136 of the EC Treaty has enjoyed much less concrete realisation. It expresses a rather vague expectation that with increasing economic integration, the general living and working conditions within the Community will be harmonised. Concrete action, however, remains within the authority of individual member states.

Only with the forthcoming realisation of the internal market at the beginning of the 1990s was the dimension of

the social Community put on the agenda, since the states with high labour and social costs feared a destabilisation of their competitive positions.

With the 1989 adoption of the Charter of Fundamental Social Rights and the treaty establishing the EU (Maastricht Treaty, 1 November 1993), the 'agreement on social policy' received a legal advancement – in the same way as the principle of majority was allowed with regard to the labour and social Community legislation for the 14 signatory nations (without the United Kingdom).

At the same time, a 'two track' Europe was created, at least as far as social policy is concerned, by having regulations that need not apply to the United Kingdom. The benefit is that nations of lesser economic power can gradually harmonise with regard to economic and social convergence, while more advanced nations need not lower their levels of efficiency.

Thanks to the 'social dialogue', a further innovation was generated. This was the right to hearings and to propose or nominate on behalf of the unions and management *vis-à-vis* the European Commission.

If the social partners agree on regulations autonomously on a Community-wide level, these are then converted into European law. This has, however, hardly been the case. The few exceptions have included the formation of European works councils (→*industrial relations constitution*).

It was only with the participation of the United Kingdom in the social agreement in 1997 that the basis for a unified and comprehensive European social policy was created for all member

states. As the socio-political strategy plan of the European Commission from 1998–2000 already suggested, the emphasis lay – in view of the Community-wide high rate of →*unemployment* – on employment policy (and not on the social protection policies).

Standardisation in the direction of a conceptually harmonious European social policy is, for reasons of different historical development as well as political and cultural conditions, unlikely to come to fruition in the foreseeable future. This is especially so when one considers institutionally important areas such as social security, dismissal protection and autonomy in bargaining, as well as the active labour policy participation that remains subject to the principle of unanimity – and thus subject to the authority of the individual nations.

In future, European social policy is likely to seek individual measures for harmonisation within the areas of pension, health, nursing care and unemployment so that these areas do not go counter to economic integration. The primacy of economics over social policy would thus remain.

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## EU: Trade policy

Customs unions such as the European Union were authorised by the General Agreement on Tariffs and Trade (GATT) and in the World Trade Organization (WTO) (*→international organisations*) because it is assumed that to phase out trade barriers between the member countries without at the same time erecting more customs barriers for third countries, would bring about an opening of national markets worldwide. At the same time, GATT/WTO expects member states to get actively involved in the liberalisation of the global economy.

In 1958, the European Economic Community (EEC) expressed the theme of its trade policy (Article 110, EEC contract) as follows: ‘The creation of a customs union reflects the desire of the member states to contribute to the gradual removal of the limitations to international trade and to phase out customs barriers, in the interests of all parties involved and for the promotion of a harmonious development of world trade.’

This objective has remained unchanged and was, as Article 131, incorporated into the EU Treaty of Maastricht/Amsterdam. It was reinforced by the maxim that the Community respects the principle of an ‘open market economy on the basis of free *→competition*’ (Articles 4, 98, 105, EC Treaty).

In 1970, trade policy was transferred from the member states to the Community. The European Commission submits proposals to the Council of Ministers for the implementation of a common trade policy, to

which the Council empowers the Commission (Article 133 EC Treaty).

The EU trade policy has accepted the empirically proven fact that division of labour and open markets are the best way of creating *→income* and *→employment*, while at the same time increasing the standard of living. Through open, competitive markets, productivity gains can be achieved that would otherwise not be possible. This connection is not always obvious, because the ‘creative destruction’ associated with competition – meaning the progression to more demanding products and activities – results in job losses in those branches which are no longer able to compete. Economic policy is supposed to react to this by widely promoting education and further training and by, if necessary, offering the ‘victims’ of progress temporary support (*→unemployment: social security*).

As the largest exporter of goods and services, the EU is clearly interested in gaining access to foreign markets. In addition, it is increasingly recognised that opening its own market yields higher prosperity and employment gains than the removal of trade barriers on the part of the trading partners. Trade barriers, whether practised at home or abroad (protectionism), will not prevent transformation but will only delay it at enormous cost.

Starting in 1985, the rules of competition in an open market were implemented with particular consistency and success in the EU, concurrently with the Domestic Market Programme. The introduction of freedom of movement for goods, services, labour and capital (four types of freedom), invigorated internal European trade and resulted in

lasting, positive effects on income and employment in all EU member states.

Consumers and →*entrepreneurs* can choose from a greater variety of products at lower prices, which increases buying power. The costs of travel, goods, transport and communication of information and news have gone down dramatically. Today, both European and non-European suppliers can sell their merchandise in any EU country under the same legal conditions.

Service providers, by contrast, remained subject to certain limitations, which is why at the beginning of 2001 the European Commission started implementing a package of steps intended to promote the integration of the European service markets.

By the end of 2002, any obstacles to the transnational exchange of services were supposed to have been identified and eliminated as far as possible, so that service providers can just as well conduct their activities in the whole of the EU or in just one member country. For the users of services, be they companies or consumers, this means, as it does for goods, a larger number of suppliers who are not only competing with each other but who are also competing in terms of quality and innovation, thereby benefiting the consumer. As the freedom of services in Europe is realised more consistently, the transition from the industrial to the service and information society is sped up. If the same proportion of the workforce were employed in the services sector as in the United States, there would be an additional 36 million jobs in the EU.

If in the European domestic market the principles of competition, division of labour and unhampered market

access have a positive effect, the same must apply in the global market – about one-fifth of which is represented by the EU. This means that the more the EU opens its external borders with third countries, the more it will benefit in terms of income and employment. For most industrial goods this realisation has resulted in openness of the European market, which with average customs duties of 2.4% must be seen as exemplary.

The politically motivated consideration of specific interests is, however, causing the EU to continually make exceptions despite its better knowledge. At the instigation of just a few EU member countries, the European import of textiles and clothing stands out through its quantity limitations and high customs duties. This harms not only buyers in Europe but many developing countries which depend on the export of these products. These developing countries are deprived of the possibility of sales opportunities in the context of the international division of labour. They are also deprived of the opportunity of taking responsibility for their own progress.

Another example of the lack of consistency in EU trade policy is the customs duty of 10% on imported cars, which from the macroeconomic perspective is an unjustifiable interference in the market process (US: 2.5%). The import limitations and subsidies for the benefit of the coal mining industry (about €100 per ton) is another example which shows up the problems and costs of protectionism.

In addition, the European agricultural policy is increasingly becoming an economic nuisance, both inside and

outside the EU. The policy's one-sided focus on protecting European production, which by international standards is uneconomical, puts an extra burden on EU consumers and taxpayers. At the same time, as in the textile sector, many developing countries are deprived of market access to the European consumers and their buying power.

→*Deregulation* and the opening of the agricultural markets will be difficult and sensitive topics at future international talks under the umbrella of the WTO. There, the EU will have to submit to being judged by its own principles of conduct in a market economy.

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### EU: Transport policy

The 1957 treaty establishing the European Economic Community (EEC) already contained statements about a common transport policy: Article 3 in general form, Articles 47-87 more concretely regarding common rules. This policy concerns, among other things, issues of transnational traffic, rights of passage for transport enterprises in a member state in which they do not reside, road safety and the elimination of discrimination. This concerns Community agencies as well as transnational transport between the member states. The terms of reference

are not very concrete and are limited to the rail, road and internal waterways.

The cause of the impreciseness was the substantial difference in viewpoints regarding the conceptual organisation of the →*transport policy*. While the EEC Commission at that time, as well as some of the smaller member countries, demanded a competitive regulatory framework, Germany, France and Italy oriented themselves along the lines of the 'particularities of transport' theory. According to these teachings, the area of transport is an exception where the principles of market competition do not apply. This anti-competition perspective has been anchored in the EC Treaty (Article 75 (1)).

Despite many initiatives on behalf of the European Commission in favour of a liberalisation of market access and a gradual dismantling of national interference with transport tariffs, as well as coordinated frameworks for →*competition* within and between the transport carriers in Europe, almost every attempt to create a structured European transport policy was condemned to failure.

It was only with the European Parliament's claim to the European Court of Justice (EuCJ) regarding the EU Council's failing to act and its policy of procrastination, and the EuCJ's subsequent decision to extend free movement of cross-border services to transport from 22 May 1985, that a change in common transport policy became visible. The EuCJ found against the quantitative restrictions, but did not give clear criteria for the establishment of a new policy.

The mostly positive experience with already liberalised transport markets and the massive academic critique on



the 'particularities of transport' theory, motivated the government heads to create a free European transport market without quantitative restrictions in the same year, until 1 January 1993.

The subsequent liberalisation efforts applied first and foremost to the road transport of goods. Partly with the support of the member states, and partly against their substantial resistance, the mandatory margin tariffs were somewhat abolished and free price formation in transnational transport was implemented. The Community licence took the place of the quantitatively fixed transport authorisation, which made it possible to transport goods within the EU without restrictions. It also eliminated the restriction on cabotage that prohibited enterprises from performing transport services in another member state.

Gradually, the liberalisation spread to other facets of transport, although in varying degrees: the liberalisation of tariffs and market access regarding air traffic between the member states meant that market access within the member states was also liberalised. At the same time, the navigation of national inland waterways was opened to all enterprises. With regard to the rail system, the EU requires separate calculations for the rail network and the train operation, as well as the discrimination-free access to the national networks for all railway operators – public or private.

With its more recent activities, the EU Commission has aimed for a fairer allocation of transport-dependent costs to their respective initiators, regarding the costs for the use of the transport routes (route costs), environmental costs as well as the costs that arise from

traffic congestion. Further, by introducing uniform technical standards, it is trying to create internationally harmonised control systems within the realm of air traffic control and coordinated transport route planning with regard to trans-European transport networks. These should allow both economical and smooth flowing traffic. Finally, in the light of →*EU enlargement* the Commission is striving to liberalise transport relations with the new member countries – and to lead them to a common transport market.

Despite the focus on a stronger market competition orientation, European transport policy still faces substantial policy planning tasks. Thus, the member states have a range of possibilities for action within the framework of the principle of subsidiarity that allows them to avoid the desired competition by massive market interference.

On the other hand, where the Community has the appropriate competencies, no adequate realisation of the Community law has occurred. Short-distance public transport is, therefore, despite the demand for more competition through tendering procedures, still a closed market to which private vendors have only very limited access. Most often in regard to air transport and sea ports, the general prohibition of competition-inhibiting aid →*subsidies* is circumvented by the issue of special exemptions or violations. Rail transport, too, has not been able to eliminate the state's influence on the rail networks in many countries, thus making access to rail networks sometimes impossible for newcomers.

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## Family policy

The term 'family' is rooted in civil law and defined as parents living with their children in one household, while the parents may or may not be married to each other, may never have been married or may have single status. This means that marriage is no longer a prerequisite for the existence of a family, which instead now means the sole or shared custody for one or several children.

Family policy in Germany is therefore understood as all those protective and supportive measures that are aimed either directly at the children or indirectly at their parents.

The protective measures provided by the law start with protection for the unborn child and protection of the mother, as well as the legal right to claim maternity leave and part-time employment. The measures continue with child support and support for adolescents, protection of the youth and employment protection legislation.

Where supportive measures are concerned, one has to distinguish between tax relief (tax split of family

income, child and childcare allowances) and social transfers, such as child benefit, educational aid and aid for the protection of the unborn child. Since 'family expenditure compensation' was renamed in 1996 as 'family contribution compensation', it has become possible to claim either child benefit or a tax rebate.

Time spent on childcare and education is recognised and taken into account in the calculation of old-age pensions and pension plans for widows and widowers. The child allowance featured in Germany's latest pension reform plan has added more provision for retirement, covered by capital resources. All this supports and promotes parenting. The situation concerning the legally prescribed national →health insurance where dependants have free cover, and also concerning the additional child allowance for the unemployed in the social security sector (→unemployment: social security), is similar. Besides these purely material contributions, aid in support of the cohesion and educational effectiveness of families through marriage, parenting and educational counselling as well as family planning must be mentioned.

Just as the new term 'family contribution compensation' makes clear, children do not represent a burden on society, but parents through the investment of money and labour are making an essential contribution for the continued existence of society. It is therefore the joint task of the federal government and the states at government level, and that of the municipalities at local level, to build a society which favours the child and the family. Besides the provision of affordable living space – which must be

tailored to the needs of children and ought to be located in child-friendly surroundings with a family-focused socio-cultural infrastructure – a satisfactory range of supportive and complementary facilities which assist the family in the care, education and training of their children should also be available, together with health-promoting measures and institutions.

The most important task family policy-makers have to tackle in the future seems to be, on the one hand, the creation of conditions which favour the combination of parenting with gainful employment, particularly for single parents; and, on the other hand, ensuring that domestic activities receive more general respect.

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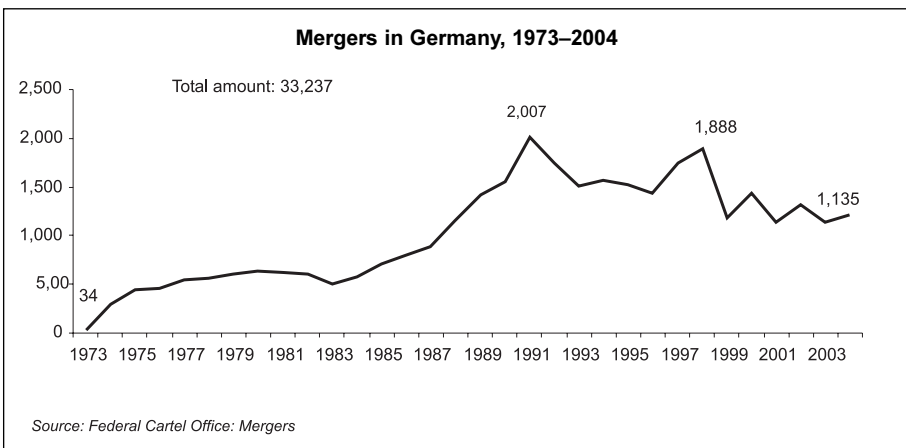
Hans Jürgen Rösner

## Federal Cartel Office

The Federal Cartel Office (FCO) is the most important German competition authority. As an independent federal authority, it falls under the Federal Ministry of Economics and Technology. In terms of the relocation programme, its headquarters were transferred from Berlin to Bonn. The FCO is primarily responsible for the implementation of the →*Act Against Restraints of Competition* which came into force on 1 January 1958 as a competition watch-dog. The FCO has a staff of about 300 employees and officials, of whom about 150 are at executive level – almost exclusively lawyers and economists, in approximately equal numbers.

Decisions regarding mergers (amalgamations), monopolies and abuse of market power are taken by the 11 decision-making divisions of the FCO, each of which is responsible for certain industries.

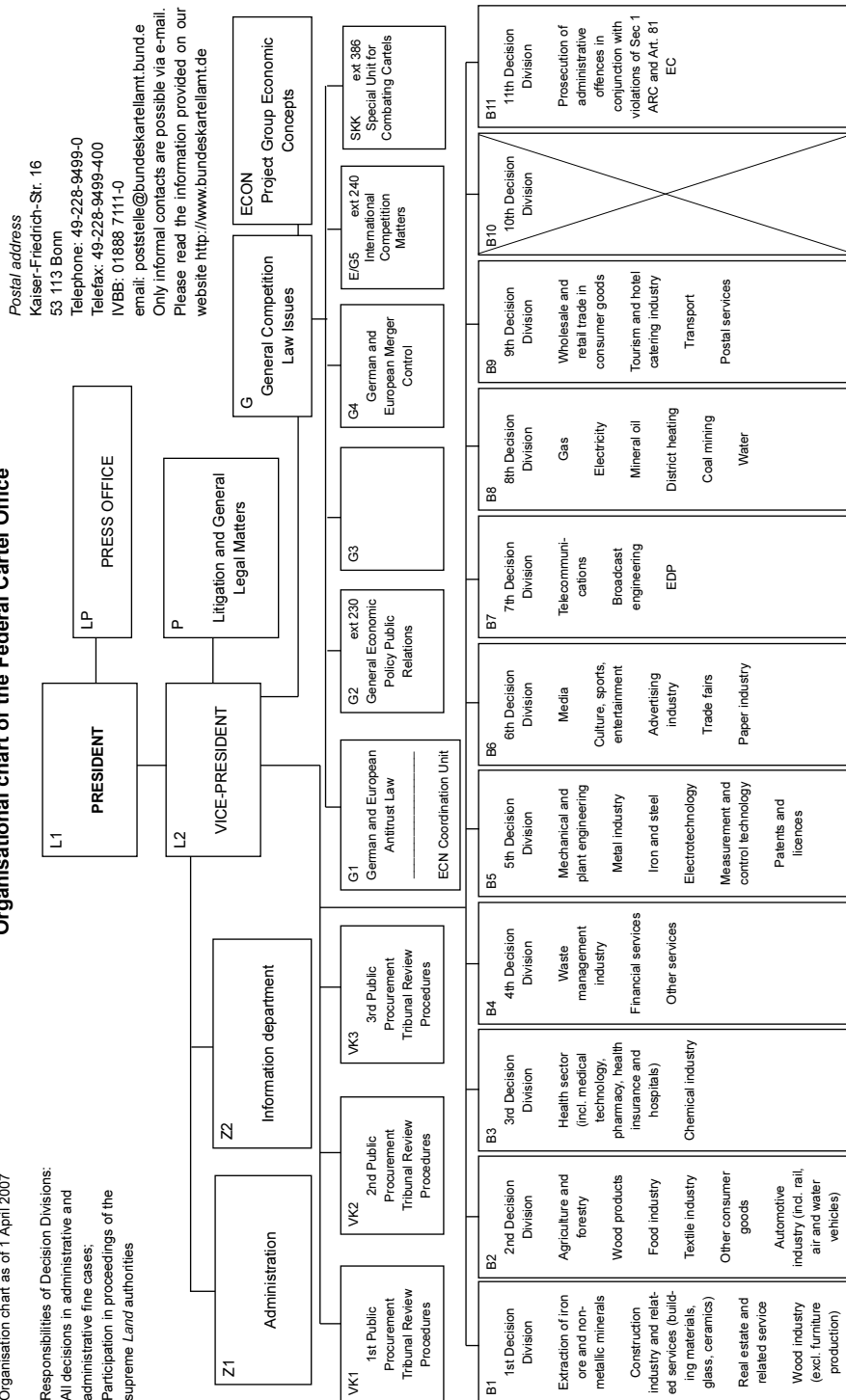
A decision on each case is made by a committee consisting of the director of the division concerned and two associate members of the same division. In this capacity, the decision divisions are



### Organisational chart of the Federal Cartel Office

Organisation chart as of 1 April 2007

Responsibilities of Decision Divisions:  
 All decisions in administrative and administrative fine cases,  
 Participation in proceedings of the supreme *Land* authorities



not subject to any directives but make autonomous decisions.

Concurrently with the sixth amendment to the Act Against Restraints of Competition which came into force on 1 January 1999, two additional federal public procurement divisions were established at the FCO. The public procurement divisions are responsible for the examination of the placing of public orders in the area of federal government responsibility.

The FCO follows up on all restraints of competition which are effective in Germany. Some of its specific functions include enforcement of cartel prohibition, the monitoring of abuse and merger control (→*concentration*). But the FCO is responsible for the enforcement of cartel prohibition and the monitoring of abuse of power only when the restriction of competition extends beyond the borders of a German federal state. If the effect is limited to a state, the respective regional competition authorities follow up on the alleged competition offences. Merger control, however, is exclusively dealt with by the FCO.

In its capacity as the competent authority, the FCO also attends to all matters which have been transferred to the member states in terms of the competition regulations of the European Economic Community Treaty. Finally, on the basis of its practical experiences the FCO makes official statements on matters regarding the political and legal aspects of competition.

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Internet: [www.bundeskartellamt.de](http://www.bundeskartellamt.de)

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## Federal Employment Agency

The German Federal Employment Agency (FEA) is an officially registered autonomous body with legal capacity and directly answerable to the federal government. Autonomous organs (through the employees, employers and the public bodies) are the Executive Committee and Board of Governors as well as the administrative committees of the state employment offices and employment agencies. According to the Social Security Code III (from 16 December 1997), the FEA is the regulatory body responsible for 'employment promotion'.

Historically, the FEA, founded on 1 May 1952, takes the place of the German Reich Institute for Labour and Unemployment Insurance, established on 1 October 1927 and after the National Socialist 'synchronisation', based on the Employment Creation and Unemployment Insurance Act of 16 July 1927, which had closed a gap in Bismarck's social security legislation.

At the beginning of 2002 the federal government introduced a commission for 'modern services in the job market', the so-called Hartz Commission. Its task was to make the German job market more effective and labour administration more efficient. On the basis of the proposals made by the Hartz Commission, four laws concerning modern services in the job market (Hartz I-IV) were ratified. As part of a reform process, the Federal Labour Office was renamed the Federal Employment Agency on 1 January 2004.

As long ago as the 19th century, municipal labour offices had sprung up especially in the big cities. Growing

mass unemployment during the Weimar period in the wake of the special labour requirements of a war economy and the emergence of a variety of institutions for labour registration and unemployment support made it obvious that a comprehensive, neutral and efficient labour organisation was needed.

Linking a public labour service with income protection in the event of →unemployment can be regarded as a first step in a preventative (prophylactic) →social policy in relation to the risk of unemployment. The Employment Promotion Act of 1969 and its amendment of 1997 (Social Security Code III) had reinforced the emphasis on finding work, preserving employability and the integration into regular gainful employment through the expansion and systematic development of the sophisticated methods of an active →labour market policy.

In view of the specific imperfections of the job market, such institutional arrangements for gainful employment (institutionalised job market) can, in economic theory, be seen as a path to greater prosperity.

The founding fathers of the →social market economy, in their desire to overcome the historical problems of the 'worker question', had made the defeat of unemployment the central issue of their economic policy (Ludwig →Erhard, Alfred →Müller-Armack and Walter →Eucken). The FEA can therefore be regarded as an indispensable element of the systematic order of the job market in the social market economy (→labour market order).

Despite the improved situation of workers in Germany in the decades since the 1950s, earned income repre-

sents a crucial security for the livelihood of the majority of workers. Private insurance against the risk of unemployment is not on the cards due to the collective interconnections of losses in the event of economic, structural and growth crises. Besides, the fact that the individual can have an impact on the risk of unemployment ('moral hazard') means that it is a risk which cannot be privately insured.

There is no uniform total labour market. Rather, it is divided into specialised technical, qualification-based, industry-based and regional labour markets. The labour market is characterised by a particular lack of transparency of supply and demand. Work contracts are incomplete and the mobility of workers is limited. These conditions make it as difficult to bring about the smooth interlocking of →supply and demand in the labour market as it is to steer the resource 'labour', both at individual and macroeconomic levels, towards optimal allocation from which high economic yields can be obtained through employment, in quantity and quality terms.

With the help of information about the state and development of the labour market through vocational guidance and the finding and allocating of jobs as well as through the speedy occupation of open places, the FEA can support equilibrium in the labour market (Social Security Code III, section 1). By offering this service, the FEA creates an important opportunity for employers and employees to become aware of their special responsibility for the development and preservation of operational efficiency and for employment (Social Security Code III, section 2).

Despite the abolition of the former labour office monopoly (allocation monopoly), the FEA, even in a phase of increasing internet job websites, is the only comprehensively competent, neutral, available and decentralised institution of its kind; it has 10 regional managements, 180 employment agencies and 660 offices. The FEA is the officially appointed service provider (public employment service) for all labour questions relating to →*vocational training and further education*, mobility, occupation and self-employment.

The granting of wage compensations in the case of unemployment (unemployment pay, maintenance money, unemployment relief) depends on a justified contribution-based claim, and in principle depends on the previously earned income. The level and duration of claims (as well as their cessation when a new job is started) are often seen, by international comparison, as being one of the causes of persistently high unemployment.

In order to be able to offer successful services for employees and employers and the preservation of employability through preventative job promotion, the FEA requires scientific analyses of the labour market and employment; these are compiled by the FEA's Institute for Labour Market and Occupation Research (Social Security Code III, section 282).

Besides ongoing monitoring of the implementation of business policy goals, labour market policy instruments are subjected to a constant outcome analysis. More than once, an analysis of the active labour policy has led to modifications and improvements of the effectiveness and efficiency of employ-

ment promotion. Furthermore, it demonstrated that the labour market policy of the FEA can be effective only in combination with a macroeconomic growth and →*employment policy* (see section 1 Employment Promotion Act and Social Security Code III, section 1). Although this is not always taken into account, the restrictions of active labour market policies, particularly of job creation, were felt during the fight against mass unemployment in the transformation and adjustment process of East Germany.

For the assessment of job creation measures (in the presence of high unemployment and lacking demand for labour), general legal principles and regulations concerning the administration of a welfare state are significant. Labour market relief, the preservation of job qualifications and employability through educational measures and development contributions for the regional infrastructure, as well as bridging functions for long-standing job-seekers and others who have difficulties finding work, play an important political role.

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### **Federal Republic (*Bund*), federal states (*Länder*), municipalities**

In a multilevel state, the competencies for public tasks, expenditures and incomes must be regulated between the different levels. Regarding the task distribution, two fundamental models are applicable: for a central solution the tasks are preferably assigned to the super-ordinate level. The advantages of such a system are seen particularly in greater administrative efficiency, since thanks to the bundling of competencies for the purpose of national task fulfilment, costs can usually be saved.

For a decentralised solution, however, the tasks tend to be assigned to the subordinate level. The advantage of such a regulation lies specifically in a greater efficiency of supply, since the national task fulfilment can take place closer to the citizen. In each case, therefore, the advantage of the one equals the disadvantage of the other solution: however, the argument against consistent centralisation is that certain public services are meaningful only if they can be offered locally (e.g. service provision).

Consistent decentralisation, meanwhile, is limited by the desire to ensure equal access for all to other public services (e.g. avoidance of a downward West–East or urban–rural gradient). For the three-tiered regional government authorities in Germany – the Federal Republic (*Bund*), the 16 federal states (*Länder*) and the more than 16,000 municipalities – the principle of subsidiarity applies: national services which are limited in their effects to an area or a region are to be regulated locally and/or regionally. Only if the effects go

beyond that will the next level authority be responsible.

It follows that the Basic Law, which is committed to federalism, tends to assign the execution of sovereign powers and the fulfilment of public tasks – including legislative competence – to the states. First of all, and not in line with this, to deal with certain central affairs (e.g. national defence), the *Bund* has been invested with exclusive legislative powers. Second, the *Bund* also has concurrent legislative powers, where the provision of equal living conditions for all citizens or the preservation of legal or economic unity (e.g. the judiciary and the welfare service) are concerned. Third, the *Bund* can participate in joint tasks if relevant measures by individual states are of national relevance and represent an improvement of living conditions (e.g. agricultural structure and coastal protection). Lastly, the municipalities are left with voluntary tasks (e.g. theatres), legally assigned mandatory tasks (e.g. water supply) as well as with matters they carry out as agents of the *Bund* and the *Länder* (e.g. registry offices).

Geographically, besides the distribution of functions among the domestic regional government authorities, the European Union should count as the fourth level. When the principle of subsidiarity is applied (e.g. Article 5 of the EEC treaty) it, too, has been assigned its own competencies (e.g. the monetary system). At a national level, on the other hand, this also applies to the so-called →*parastatals*, which are tasked with social safety (e.g. unemployment or pension insurance). The distribution of responsibilities and functions goes together with expenditure distribution,



which has to be ensured by an appropriate distribution of funds.

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### Financial constitution

The financial constitution is a set of guidelines for the coordination of public activities. In Germany, this sector is subject to Article 20 of the Basic Law, which deals with the federal system. This system is based on 'regional government authorities' – the federal government (*Bund*), the states (*Länder*) and the municipalities. Beyond these stands the relationship with the →*European Union* (Article 23 of the Basic Law). The core of the financial constitution can be found in Chapter X of the Basic Law entitled 'Finance'.

Whether or not a particular issue ought to be the government's responsibility depends – from the point of view of the market economy – on whether public sector involvement would achieve more substantial welfare gains in that case than the otherwise autonomous private sector. If public sector involvement is considered desirable, the question is whether the issue should be dealt with by the federal government, the states or the municipalities.

Public sector involvement is characterised by specific competencies at dif-

ferent levels, which means that each case should be allocated to either local, regional or central powers, based on its own merits.

It also has to be taken into account that issues which are dealt with by the public sector and the relevant expenditure (→*public expenditure*) have to be reconciled with an appropriate budget, which is administered by a regional government authority. This means that, besides the federal division of labour, the functioning of the public sector also requires proper regulation of finances (→*public revenue*).

The powers for the public sector responsibility are:

- *Decision-making competence I:* Which regional government authority is competent to make decisions regarding how the implementation of these responsibilities is to be organised?
- *Executive competence:* Which regional government authority will be tasked with the execution of these responsibilities?
- *Financial competence:* Which regional government authority is responsible for the arising expenditure in the context of the performance of these responsibilities?

Regarding the expenditure, which is for the most part covered by taxes and borrowings, there are the following powers:

- *Decision-making competence II:* Which regional government authority takes decisions on the structuring of these revenues?

- *Administrative competence*: Which regional government authority is responsible for revenue collection?
- *Competence of disposal*: Which regional government authority is the final recipient of these revenues?

These six areas of competency take care of the regulation and structuring of the system. What is still missing is the naming of the specific objectives which the organisation of responsibilities, the procurement of revenues as well as their disposal has in view. Basically, the financial constitution is supposed to ensure that public sector responsibilities and competences benefit the public, while at the same time ensuring the cost-effectiveness of government actions. In addition, national unity must be safeguarded.

One initially more specific objective emerging from these basic premises lies in the aspiration to a balanced economy on the whole, as well as compensation for the uneven economic power of the different regional government authorities (Article 104a, Basic Law) and also in the approximation to more equalised living conditions (Articles 72, 106, Basic Law) throughout the entire country.

Against this background, and in conjunction with the regulations and structures discussed above, a number of central guidelines for the 'organisation of public finance' can be deduced.

In the first place, regarding the allocation of 'decision-making competence I', a high degree of autonomy and self responsibility is desirable. In order to secure the implementation of this criterion for the relationship between 'mar-

ket' and 'state', and also for the relationship between the different regional government authorities, recourse is made to 'the principle of subsidiarity'. This allows for responsibilities to be allocated to a higher level (e.g. the federal government) only when the lower levels (the states and municipalities) have been shown to be incapable of achieving a satisfactory result on their own.

Second, this goes together with the emphasis on the independence of the regional government authorities – 'the principle of autonomy'. If this is not guaranteed, the stability of federal structures as well as the transparency of government activities are endangered. This is why the organisation of public finance provides for separate budgets for the regional government authorities (Article 109, Basic Law).

Third, it is intended that each level with specific tasks shall have the responsibilities allocated to it, together with the autonomous right to dispose of the required funds. This means that each particular decision-making area is also assumed to be the most competent in both the financial and the organisational aspects of their areas of responsibility. It also ensures that unilateral dependencies between the regional government authorities are avoided. The causal relationship between decision-making competence I and the competence of disposal is based on 'the principle of connectivity'.

Fourth, it is intended above all to achieve an advantageous division of labour between the regional government authorities. Both the executive power and the fiscal power should be allocated to the level that is able to deal with them in the most cost-effective manner.

Fifth, where the financing of public interventions is concerned, and since especially the private sector has been encumbered with contributions of a compulsory nature, the needs of each of these 'groups of victims' should be taken into account to the greatest possible extent. Therefore, according to the principle of fiscal equality, 'decision-making competence II' (regarding a particular revenue) must be granted to that regional government authority which represents the agents who are affected by the public interventions in question.

Sixth, the financial constitution has to ensure that regional government authorities which find themselves in an unfavourable financial situation are still able to carry out their responsibilities.

This rule is derived from the principle of solidarity (community solidarity), and requires above all rules with regard to the disposal of revenue. In reality, and in particular regarding this last point, this could potentially lead to conflict with the other constituents of the financial constitution. The degree to which this applies to the German financial constitution is discussed under the theme →*fiscal federalism*.

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## Fiscal federalism

Fiscal federalism entails the provision and the application of an economic concept in order to analyse and construct a →*financial constitution*. The goal, aided by the relevant competences, objectives and structural principles, is the theoretical design of an 'optimal' system of government. A model of this sort can then be used in the assessment of real governmental structures.

Fiscal federalism can be divided into two interrelated sections:

- The distribution of public responsibilities and public expenditure between the regional government authorities (passive financial equalisation [or compensation]).
- A detailed investigation of the associated financial aspect from the perspective of funding – especially regarding tax (active financial equalisation).

In a further structural progression, it is possible to make the distinction between vertical financial equalisation (regulations between the different levels of the regional government authorities, e.g. →*Federal Republic, federal states, municipalities*) and horizontal financial equalisation (regulations between regional government authorities at the same level, e.g. between the states).

The 'allocation of public responsibilities' is exposed to the tug-of-war between forces favouring a centralised solution (through the federal government or the →*European Union*), and those factors of influence which advocate a decentralised approach (through

states and local authorities): when this happens, a central intervention by the federal government is required only when public goods (e.g. defence) are at stake and when the country as a whole is affected. Furthermore, centralised areas of responsibility allow for the avoidance of expensive dual administrative governmental structures, which also helps to ensure the impartiality and transparency of the public sector. In addition, a decentralised organisation makes a general overview difficult; this is particularly true in those cases where the decentralised levels do not possess the necessary powers of intervention or the necessary funds (e.g. in the areas of stabilisation or distribution).

By contrast, decentralised areas of responsibility subject to regional government authorities are preferable when there are regional differences regarding needs and objectives: services offered at local level can respond to such differences with flexibility and accuracy (avoidance of heteronomy). This also means that political decisions are more accessible for the common person whose information is predominantly derived from local sources (a detailed view). Decentralised administrative structures lower the costs (especially communication costs) for the individual citizen in his/her dealings with government institutions. Finally, this concept makes it possible to define and understand the relationship of the regional government authorities to one another in terms of the idea of competition (competitive federalism).

It can be assumed that – comparable to the efficiency effect on the open market – competitive pressure forces the respective public service provider to

fit the public services to the requirements of the people, while at the same time monitoring the costs and effectiveness of specific services. If this were not done, private economic agents could make use of their assumed mobility and relocate to other regional government authorities ('voting with their feet').

The fact that the above discussion of structures and institutions may help to find where in the regional government authority specific public responsibilities should be placed, may serve as a transition from theoretical discussion to practical implementation. In reality, however, such recommendations are frequently not adhered to – for example, in the case of historical developments at the respective governmental level and also due to the need to restrict the number of federal units in order to maintain manageability.

According to Article 30 of the Basic Law, the main focus for the allocation of decision-making powers seems to lie with the states. The federal government has been assigned a number of areas of exclusive legislative powers which include, in particular, external affairs, defence and monetary affairs (Articles 71 and 73, Basic Law). In practice, however, the federal government has gained a dominant position by attracting, through concurrent legislation, a comprehensive list of areas of responsibility – for example, in the fields of jurisdiction or welfare (Articles 72 and 74, Basic Law). It follows that the states retain as principal areas of involvement, mainly internal security and cultural affairs.

As a means of redressing this imbalance, the states have been granted the opportunity to participate in a multi-

tude of federal laws via the Upper House of the German Parliament. The competence of implementation belongs largely to the states (Article 83, Basic Law) and includes a large number of federal government duties, which in many instances are executed by the states in their capacity as agents of the federal government.

The federal government is restricted to its own administrative establishments, for example, for the management of the federal finances (Article 86, Basic Law). There are other areas of responsibility where regional and national interests are mixed, which suggests that regional government authorities take on the responsibilities in the areas of overlap: this is how the federal government and the states cooperate in the context of shared responsibilities (mixed financing), dealing with the construction of tertiary educational institutions, improving regional economic structures, agriculture and coastal protection (Article 91, Basic Law), as well as the joint involvement in educational planning and research (Article 91b, Basic Law).

Successful management of the financial side aims at boosting the capabilities and the vitality of the federal organisation concerned. Added to this, political objectives enshrined in the constitution, like the striving for equal or uniform living conditions (Article 72(106)(3), Basic Law), must not be forgotten.

Regarding the structure of the financial system, it must be taken into account that the provision of public services is frequently coupled with a national ripple-effect: it is to be expected, for instance, that the citizens of a

certain district will make use of the subsidised cultural facilities of a town as their main centre because, for financial reasons, such facilities are lacking in their own area. The main centre is then entitled to financial compensation for this additional strain on its resources. Otherwise, planning of the nature and extent of its involvement would not make allowance for this additional regional service delivery, which means the neighbours' needs would not be catered to.

All in all, such guidelines require a balancing act between the empowerment of the different regional government authorities and the concomitant promotion of autonomous planning, and a due recognition of the contribution and integrating effect of federal institutions. The goal of preserving the relationship between citizen/taxpayer and the regional government authority (principle of connectivity) while at the same time stimulating →*competition* between regional government authorities, is best served by investing the different regional government authorities with the power of disposal of independent revenues on the basis of the system of separation.

This last point, however, brings a number of significant disadvantages in its wake: while citizens are in danger of incurring multiple charges, greater administrative expenditure is also to be taken into account. There is also the question of whether this system can provide the regional government authorities with adequate financial resources: due to socio-economic differences between the regions, the revenue potential of regional bodies is uneven. Public services, however,

depend on regularity of revenue as well as on a degree of flexibility as far as expenditure is concerned. If this is not the case, severe financial risks could result – for example, due to the susceptibility of many taxes to economic change. This makes tax distribution by allocation preferable to the system of separation. While this system of allocation causes the competence of disposal to be placed with one of the regional government authorities, fiscal revenue is, however, distributed among the regional government authorities.

Financial redistribution in Germany represents (Article 104 a ff., Basic Law) a mixed system, containing elements of both the systems of separation and of allocation. In this way, taxes on petroleum products are allocated to the federal government, death duties are handled by the states and the trade tax is a primary source of revenue for the municipalities. The comparatively much higher income and sales tax revenues, by contrast, are common; they are divided among the regional public levels according to certain percentages.

In order to balance the inequality of revenue between the states, and in order to accommodate their respective financial needs, their own revenues are divided up according to a specific formula, and used for horizontal redistribution (state finance redistribution). The accompanying measures ensure that the financial capacity of the poorer states is raised to a level of at least 95% of the national average. In addition, the federal government makes provision for complementary federal allocations which are granted to the disadvantaged states for their ‘general financial needs’ (Article 107(2), Basic Law).

The regulations governing state financial equalisation used to be strongly criticised for their equalising effect on the financial capacities of the different states and for their disregard of the idea of competition. In a judgment of 11 November 1999, the Federal Constitutional Court found that the procedures used for financial capacity assessments, as well as for the complementary federal allocation system, in their current form were unconstitutional. The legislature was given until 31 December 2002 to deal with the resulting need for reform, which is to be approached through the Financial Specification Act. It remains to be seen, however, whether the agreements made at the end of June 2001 by the federal government and the federal state heads of government regarding future financial equalisation can be reconciled with the principles of the judgment.

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## Foreign trade

All cross-border economic transactions of a country are part of its external trade. These include exports and imports of goods and services, interna-

tional movements of finance and capital equipment and payments to supranational institutions.

As an economy, Germany is defined by its dependence on foreign countries and its openness towards global trade. At first sight this does not seem obvious, but it becomes clear by looking at the numerous products in Germany carrying the label 'Made in China' or 'Manufactured in the European Union'. The dependence of jobs at Volkswagen or BMW on changes in demand in the United States explains this situation further.

In the statistical surveys on foreign trade, these interdependencies are regularly reflected in high import and/or export quotas (proportion of imports and exports of the gross domestic product) and reciprocal trade relationships with other EU states. Foreign trade transactions show up in the national *→balance of payments*.

The three major components of the balance sheet illustrate the value of:

- all exported and imported goods and services throughout the year, current cross-border transfers as well as net

<b>German balance of payments, 2006</b>			
in € million			
	<i>Credits</i>	<i>Debits</i>	<i>Balance</i>
<b>Current account</b>			
1. Foreign trade (exports / imports)	893,635	731,479	162,156
2. Complement of foreign trade	6,670	25,395	-18,725
3. Services	141,934	164,365	-22,431
<i>of which: foreign travel</i>	<i>26,091</i>	<i>58,895</i>	<i>-32,804</i>
4. Income from employment and investment	187,818	164,845	22,973
5. Current transfers	19,876	46,671	-26,795
<i>of which: EU net payments</i>			<i>-12,777</i>
6. Balance of current account (1+2+3+4+5)			117,178
<b>Financial account</b>			
7. Direct investment	34,168	63,311	-29,143
8. Commercial papers / securities	160,626	165,684	-5,058
9. Other capital transaction	94,337	209,687	-115,350
10. Reserve assets			2,934
11. Balance of financial account (7+8+9+10)			-146,617
<b>Remains and deferred items</b>			
12. Not itemisable transactions			29,630
Foreign exchange account (6+11+12)			191
<i>Source: Deutsche Bundesbank</i>			

factor incomes in relation to other countries (balance of current accounts);

- capital exports and imports resulting in changes to the demands from and commitments towards other countries (balance of capital transactions); and
- changes to the demands by the central bank towards other countries, the latter consisting predominantly of foreign currency reserves (foreign exchange balance).

Foreign trade and its theory tend to be divided into real and monetary foreign trade theory. The real foreign trade theory explains the structure of the international division of labour and the advantages of a global free trade organisation.

Countries eventually specialise in the production of certain goods due to the local unavailability of factors of production, or because of technical or economic obstacles to a production process, or due to differences in quality. This means that of two countries using similar methods to manufacture the same product, one is likely to be able to manufacture or sell it for less.

The main justification for foreign trade, however, lies in comparative cost advantages between different countries. While two countries may be manufacturing an identical product, their costs may differ because one country has a lead on productivity, or due to an unequal supply of the factors of production labour (quantitatively, qualitatively, human capital) and capital; this leads to differences in the wage and

capital costs, and thus to differences in the unit cost prices (→*business accountancy*).

A country will tend to concentrate on the production of goods which it can manufacture at a competitive price. Some of these goods are sold abroad in exchange for products which in the importing countries would be relatively expensive to make. In this way, productivity and the range of consumer goods on offer increase everywhere.

The monetary theory of foreign trade tries to explain which factors influence a national balance of payments, which mechanisms contribute to its equalisation, what causes exchange rate fluctuations on the foreign exchange markets, and how this affects the →*business cycle*, →*employment* and price levels. This dependence of the internal stability of a national economy on the degree of its international integration raises the question of how much influence foreign trade policy can exert.

The extent to which a national economy gets involved in the world markets depends, on the one hand, on its import requirements – for example, of raw materials which may not be available locally – and, on the other hand, on the specific orientation of the foreign trade policy, which may be committed to free trade or to a protectionist line of import displacement. Thus, many countries are of the view that the free exchange of goods and services across national borders is harmful to the domestic economy since it displaces locally manufactured products. Imported goods are then charged with tariffs (import duties) and quantity restrictions (quotas) are imposed.



Exports, however, are generally regarded as beneficial for the domestic economy and the labour market, so that export-oriented industries frequently get preferential treatment. This finds expression in generous government → *subsidies*, among other things, for the promotion of international competitiveness. The situation is similar in the area of international circulation of capital which can be restricted through government measures (capital circulation controls, exchange controls).

Foreign trade relations are thus characterised by numerous politically motivated distortions, giving rise to disputes on foreign trade order theory.

Certainly since Adam Smith (1723–1790), David Ricardo (1772–1823) and John Stuart Mill (1806–1873), foreign trade theory has represented one of the cornerstones of economic theory. In these extensive early analyses, the protectionist opinions of the mercantilists – who advocated the limitation of commerce between the nations and thus a restriction of domestic consumption to locally produced goods – were proved wrong, and extensive proof for the superiority of free trade was supplied, particularly for the consumer (more goods, a large variety of goods, lower prices due to more competition).

Since then, the scientific discussion has been focused on finding an answer to the question: How do foreign trade relations come about and what are their effects? Usually, the consensus is that the free exchange of goods, capital and currency has many benefits for all countries involved, which seems to be particularly relevant in the age of → *globalisation*.

At the international level, therefore, the concepts of free trade, free capital and foreign exchange markets represent the organisational equivalent of a free market system at national level (→ *world trade order*).

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## Globalisation

The term globalisation has become a buzzword with a variety of interpretations. In its prevailing definition, globalisation describes the phenomenon of the modern international division of labour, which began during the 1970s. It is characterised by four different yet interconnected aspects, namely:

- a high degree of openness of the goods and services markets;
- internationalisation of production (multinational corporations);
- the worldwide integration of financial markets; and
- increasing international migration.

For the past three decades, the growth rates of international current and capital account transactions have been consistently higher than the

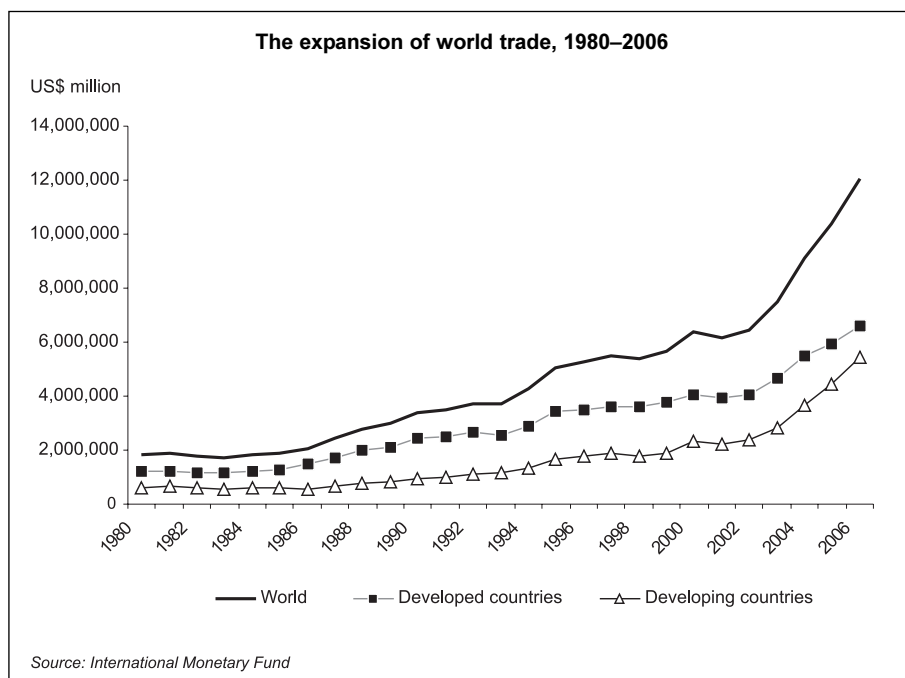
growth rates of the national products. For this reason, international as opposed to national economic activities have assumed growing importance. Added to which, especially in recent years, ever-greater numbers of people have been migrating to other countries for both economic and political reasons. The combination of these developments forms the core phenomenon of globalisation.

The following factors can be cited as the main reasons for this development:

- Liberalisation of trade and capital movements since the end of the Second World War (through the General Agreement on Tariffs and Trade via the World Trade Organization – GATT-WTO).
- Technological development. This means that over the past decades,

information and transport costs have come down to a fraction of their initial levels. At the same time, more precise production and organisational methods have made it possible to split up complex production processes and services more and more (fragmentation of the production processes) and to diversify internationally.

The consequences of globalisation are considerable and extend far beyond the economy. For the consumer, the effects consist above all in an increasingly broad availability of internationally produced goods and services at relatively affordable prices. For the producer, on the one hand, the global market offers new sales prospects, while on the other hand he/she is exposed to fierce international competition. The combined effects of new opportunities in the global marketplace and the chal-



lenges of international →*competition* are regarded as an important source of international economic growth.

The technical development of communication technologies and data processing has been especially responsible for the globalisation of the financial markets. It is estimated that the volume of the current global foreign exchange turnover amounts to 50 times that of the trade with goods and services.

In both the material and the monetary sectors of the economy, globalisation is accompanied by a greater degree of international interdependence, which is also politically relevant. This means that a national economic policy's scope for action becomes more limited to the extent to which decisions that have an impact on conditions of location and/or macroeconomic data, have rapid and perceptible economic repercussions – such as changes to the flow of capital and goods and/or to the location decisions of corporations with an international presence (→*systems competition*).

Depending on one's point of view, the shrinking scope of action of the national economic policy is either interpreted as threatening the welfare state ('race to the bottom') or as a welcome remedy against unsound economic policies ('restraint of an over-inflated →*welfare state*') (→*public debt*). The unpredictability of the international, largely unregulated, financial markets (→*speculation*) and the growing competitive pressure from abroad (cheap wage countries) are also seen as dangers to the nation state.

In assessing this state of affairs, it must firstly be noted that globalisation is the result of an increasingly open world economy. This allows the

exchange of goods and services across borders, as well as performance optimisation (international allocation of resources) in such a way that all those involved can benefit. The majority of experts regard these advantages as so significant that they are rated as a crucial contribution to the unique economic development that has taken place since the Second World War (growth effect of the external economy).

From a political perspective, the positive contribution of open economic systems to the development and stabilisation of open (democratically legitimised) social systems has to be stressed. Popular claims wanting to make globalisation responsible for the gap which is widening between poor countries and those that are rich cannot stand up to an in-depth examination. It is true, however, that countries which refuse to participate in globalisation cannot share in its successes, and are therefore falling behind on the worldwide income scale. For these states, however, globalisation is not the problem but the solution.

If globalisation nevertheless creates anxiety and fear, this is partly due to the high degree of volatility in the international financial markets, which react to shifts in economic and political data and their estimated consequences (expectation formation) with rapid and often unexpectedly violent changes to capital flows (overshooting).

Reforms of the financial markets (and of the International Monetary Fund) are aimed at improving both the transparency of the system and the reliability of the data and the participants without sacrificing the benefits of free

## Transnationality Index\* of host economies,\*\* 2002

<i>Developed economies</i>	<i>TNI (%)</i>	<i>Developing economies</i>	<i>TNI (%)</i>	<i>Central and Eastern Europe</i>	<i>TNI (%)</i>
<i>Weighted average of group</i>	11.2	<i>Weighted average of group</i>	13.3	<i>Weighted average of group</i>	19.2
<i>Simple average of group</i>	22.8	<i>Simple average of group</i>	19.0	<i>Simple average of group</i>	20.4
Japan	1.0	Indonesia	-0.1	Belarus	5.2
Italy	6.1	Saudi Arabia	2.2	Serbia and Montenegro	5.9
Greece	7.4	India	3.1	Bosnia and Herzegovina	8.7
United States	7.7	UAE	4.1	Ukraine	10.3
Norway	12.5	Republic of Korea	4.8	Albania	10.3
France	13.5	Turkey	7.4	Romania	12.1
Germany	14.3	Barbados	8.2	Poland	15.6
Austria	14.8	Philippines	8.9	Croatia	17.4
Portugal	14.8	Taiwan (prov of China)	9.1	Latvia	18.8
Israel	16.1	Egypt	9.7	Russian Federation	19.3
United Kingdom	16.8	China	10.6	Bulgaria	19.9
Switzerland	19.3	Costa Rica	12.6	Slovenia	22.3
Australia	19.4	Peru	13.2	Lithuania	23.3
Finland	20.4	Brazil	14.5	Slovakia	27.5
Spain	20.5	Thailand	15.2	Moldova, Republic of	28.9
Canada	20.7	Mexico	15.3	Hungary	30.1
New Zealand	27.4	Colombia	17.4	Czech Republic	30.9
Sweden	28.5	Bahamas	18.1	Estonia	39.0
Denmark	35.3	Guatemala	19.3	Macedonia, TFYR	41.4
Netherlands	38.4	Dominican Republic	19.4		
Ireland	69.3	Venezuela	19.4		
Belgium and Luxembourg	77.1	South Africa	19.6		
		Argentina	19.9		
		Malaysia	20.9		
		Ecuador	21.4		
		Jamaica	23.0		
		Panama	23.7		
		Honduras	26.8		
		Chile	27.0		
		Trinidad and Tobago	51.2		
		Singapore	60.3		
		Hong Kong, China	81.6		

\* Average of the four shares : FDI (foreign direct investments) inflows as a percentage of gross fixed capital formation for the past three years 2000-2002; FDI inward stocks as a percentage of GDP in 2002; value added of foreign affiliates as a percentage of GDP in 2002; and employment of foreign affiliates as a percentage of total employment in 2002.

\*\* Only the economies for which data for all of these four shares are available were selected. Data on value added are available only for Belarus, Czech Republic, Finland (2001), France (2001), Hungary (2000), Ireland (2000), Italy (1997), Japan (1999), Netherlands (1996), Norway (1998), Poland, Portugal, Sweden (2000), United Kingdom (1997), United States, China, India (1995), Malaysia (1995), Singapore (2000), Taiwan Province of China (1994) and the Republic of Moldova . For Albania, the value added of foreign owned firms was estimated on the basis of the per capita inward FDI stocks and the corresponding ratio refers to 1999. For the other economies, data were estimated by applying the ratio of value added of United States affiliates to United States outward FDI stock to total inward FDI stock of the country. Data on employment are available only for Austria (2001), Czech Republic, Denmark (1996), Finland (2001), France (2001), Germany, Hungary (2000), Ireland, Italy (1999), Japan (2001), Netherlands (1996), Norway (1996), Poland (2000), Portugal, Slovenia (2000), Sweden (2001), Switzerland, United Kingdom (1997), United States, Hong Kong (China) (1997), Indonesia (1996) and Singapore (2001). For Albania, the employment impact of foreign owned affiliates was estimated on the basis of their per capita inward FDI stocks and the corresponding ratio refers to 1999. For the remaining countries, data were estimated by applying the ratio of employment of Finnish, German, Japanese, Swedish, Swiss and United States affiliates to Finnish, German, Japanese, Swedish, Swiss and United States outward FDI stock to total inward FDI stock of the economy. Data for France, Netherlands, Norway, Sweden and United Kingdom refer to majority-owned foreign affiliates only.

Note: The simple average refers to the simple mean of the indices of the individual countries within each group, while the weighted average takes into account the weight of that each country has in each of the four shares.

Source: UNCTAD estimates

capital flows. But frustrations are also caused by the rapid and sometimes drastic structural changes to which modern national economies are generally subjected, which are exacerbated by the forced international division of labour. In this regard, the consequences of international migration are also of importance (→*international migrations*).

From an economic perspective, the migration of workers leads to a tangential adjustment of international wage relations, and suggests therefore a desirable effect in global terms. At the same time, however, within the national economies it throws up potentially explosive social and political questions (→*integration*, brain-drain) and can lead to more pressure on lower-wage categories in high-wage countries.

The free market answer to these challenges of globalisation lies both in greater individual readiness to adjust, and in the creation of basic political conditions which favour mobility (→*international organisations*).

Beyond that, the establishment of quality →*vocational training and further education* systems as well as the creation of excellent opportunities for research and development are the major challenges facing the highly developed national economies in the global context of innovation and competition.

Since the beginning of the 1990s a possible but controversial alternative answer to the global challenges is seen in the creation of regional integration agreements. This would mean the global world economy being superseded by a close network of regional economic zones whose relationship with multilateralism is under a certain amount of strain.

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Heinz Gert Preuße

## Growth

Economic growth refers to an increase of the real income per head of the population; in this case, the real income is most appropriately measured by the real gross domestic product. Due to this growth, people can enjoy a better supply of goods and services. It is important to state that this growth does not necessarily mean more goods and services (quantitative growth), but may mean that the real value of the goods and services increases (qualitative growth).

Production in a national economy occurs by means of the factors of production – labour, capital and technical knowledge. If the per capita capital investment goes up and if the technical knowledge grows, then the economy will also grow in the sense of the above definition. A rising capital input means that net investments are made. This makes investment a driving force of economic growth.

It used to be the accepted opinion that investment was the dominant growth factor. On the basis of this opinion, especially during the 1950s and 1960s, many countries adopted growth

policies focused on the preferential development of the heavy industries (e.g. steel plants) and mechanical engineering ( $\rightarrow$ *industrial policy*). However, subsequent investigations showed that increased technical knowledge, thus technical progress, is far more important for growth than investment.

This is why more attention is paid today to the promotion of technical progress than to the promotion of investment. But an economic policy that serves its purpose has to be based on an understanding of technical progress. Very recently, two potential explanations for this have started to emerge: the accumulation of human capital; and the promotion and execution of research and development (R&D).

Human capital refers to expenditure on knowledge acquisition, i.e. especially for schools, universities and advanced training courses. The accumulation of human capital therefore simply means that the next generation

should receive the best possible education and that those who are already working should continually be given further training and further qualifications ( $\rightarrow$ *vocational training and further education*).

R&D takes place in research institutions of the business sector, universities and academies. As a rule of thumb, it is assumed that higher expenditure on R&D leads to greater technical progress, but it is (still) not possible to quantify this relationship precisely.

It follows that a growth policy which is focused on the future also wants to promote the accumulation of human capital and the development of R&D activities without forgetting investment, i.e. the formation of material capital.

Finally, one has to consider the limitations of growth. The metaphor of the 'spaceship earth' is popular. It says that on earth, as in a spaceship, all natural resources are limited. This statement is followed by the conclusion that eco-

**Purchasing power of one wage minute in Germany, 1960–2005**

Item	unit	1960		1991		2000		2005	
		h	min	h	min	h	min	h	min
Bread	1 kg	0	20	0	11	0	11	0	10
Butter	250 g	0	39	0	6	0	5	0	4
Pork chop	1 kg	2	37	0	38	0	31	0	30
Filter coffee	250 g	1	46	0	12	0	11	0	9
Dress	1 item	26	28	9	33	8	34	7	0
Electricity	200 kWh	10	7	3	15	2	42	2	56
Petrol	1 l	0	14	0	4	0	5	0	5
Refrigerator	1 item	156	30	31	3	29	22	23	53
TV set	1 item	351	38	80	38	51	30	34	30
Daily newspaper	1 month	1	41	1	13	1	25	1	32

Source: German Institute for Economics

conomic growth cannot go on indefinitely since the resources that are necessary for production will eventually run out. This conclusion is nevertheless controversial. But it can also be stated that resources are saved, especially thanks to technical progress, so that their availability becomes practically unlimited ( $\rightarrow$ resource protection). Yet this applies only to natural resources, such as minerals, metals etc., but not to energy. Owing to its physical characteristics, energy cannot be saved unconditionally. In the very long term, therefore, further economic growth will be possible only if mankind solves the energy problem.

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Günter Gabisch

## Health insurance

As a protective measure against health risks, a large proportion of the German population belongs to the statutory Health Insurance Scheme. Workers and employees have to be members, provided their monthly earnings do not exceed the liability-to-insure limit (2004: €3,862.50). The liability-to-insure also applies to farmers and their family members who work on the farm, artists and journalists, the unemployed, the disabled, pensioners, students and

those undergoing practical vocational training.

Anyone who is not a compulsory candidate for membership of the statutory Health Insurance scheme may join on a voluntary basis. About 90% of the population and their families, who are co-insured at no extra cost, belong to the statutory Health Insurance scheme. About 9% of the population are members of a private health insurance scheme.

The statutory Health Insurance scheme is divided into local health insurance schemes and company health insurance schemes (for employees), social miners' and mine employees insurance, guild insurances, agricultural health insurance schemes and substitute sickness insurance societies. The insured have the right to choose between these different options.

Each one of these schemes is financed through contributions calculated in order for contribution revenues to cover current expenditure. The contribution charged is a percentage of earned income (or pension, unemployment pay, etc.) which does not go beyond the level of the contribution assessment limit (2004: €3,487.50).

In 2003, the average contribution rate was 14.4%, with the employee and employer each paying half this amount. In the case of pensioners belonging to the statutory Pension Insurance Scheme, the scheme covers half of this contribution. Members of private pension schemes, however, are charged the full contribution rate as well as in the case of company pension schemes. Recipients of unemployment benefits have their contributions covered by the Unemployment Insurance Scheme.

While private health insurance premiums are calculated on the basis of the insured individual's disease risk (dependent on age, sex, previous illnesses, etc.), the statutory Health Insurance Scheme contributions are linked to  $\rightarrow$ income. However, the fact that all insured, including the non-contributory family members, are entitled to the same quality of service means that the statutory Health Insurance Scheme has to spread out the financial burden among the insured by applying the solidarity principle. This makes it possible to provide those sectors of society with adequate risk protection for which private health insurance is unaffordable. Examples are small income earners, large families and senior citizens.

The services offered by the statutory Health Insurance Scheme include measures for disease prevention and treatment, and financial benefits to make up for lost earnings in the event of chronic illness. Services include examinations for the early detection of diseases such as cancer, heart disease and circulatory and kidney disorders, health cures and the intensified prevention of tooth decay, especially for children and adolescents. The cover includes treatment by physicians and dentists in private practice, hospital treatment and the supply of medication, bandages, recovery assistance and other remedial services.

The employer is obliged to continue full salary payments before tax for a maximum period of six weeks in the event of inability to work due to an illness for which the employee is not to blame, and also in the event of a health cure having been approved. The employee's income is therefore protect-

ed. From week seven of the employee being sick, it is the duty of the statutory Health Insurance Scheme to start paying out sickness benefit. The sickness benefit equals 70% of the regular wages up to the contribution assessment limit. Private health insurance benefits are not prescribed by the legislator, but rest on a contractual agreement between the insurer and the insured.

Over the past several decades the introduction of new medical technology and equipment, new medicines and the growing number of senior citizens have sharply increased the service costs of the statutory Health Insurance Scheme, with the consequence that both the insured and the employers have had to bear the brunt of higher contributions. In order to counteract this development, a number of reforms have been introduced into the health service. Among these are the exclusion of certain services from the service catalogue (examples: over-the-counter medications, spectacle frames, death benefit), the introduction of supplementary payments by the insured (e.g. for medication, hospitalisation, health cures, transport costs and dentures) and the so-called budgeting, which entails the introduction of upper limits for the financing of the services rendered or initiated by hospitals and physicians in private practice.

As a result of the law for the modernisation of the statutory Health Insurance Scheme, which was adopted in 2003 and came into force on 1 January 2004, further supplementary payments were introduced and existing personal contributions were increased – by a considerable margin in both cases. A new consultation fee for visits to doctors and



dentists amounting to €10 per quarter was introduced. The insured has to make a personal contribution of 10% of the price of medication, bandages and other remedial services, with the charge being not less than €5 or more than €10. Likewise, supplementary payments for the provision of other remedial services (physiotherapy, massages, etc.) and hospitalisation were increased.

More recently, dentures and the payment of sickness benefit were removed from the service catalogue of the statutory Health Insurance Scheme. Patients will now need to be separately insured at an additional fee, with the employers no longer involved in the financing of these services.

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*Albrecht Bossert*

### **Housing policy: New federal states (*Länder*)**

Housing policy in the German Democratic Republic (GDR) (East Germany) was characterised by state-controlled housing construction and rents. For political and economic reasons, the favoured construction of new buildings used prefabricated slabs, while at the same time the maintenance and modernisation of existing housing stock was neglected. Owner-occupied housing was very limited. For social and

political reasons, rents were kept low. Rents for old buildings had been frozen at 1936 price levels, while rents for new buildings were in 1981 officially determined at an average of about €0.45/m<sup>2</sup> of floor space. These rents neither reflected the value of the accommodation concerned, nor were they cost-covering. Rental income only covered 10–15% of the expenditure, with the consequence that houses fell into disrepair because no maintenance was carried out, and inner cities were becoming depopulated. Decaying housing stock was the price one had to pay for an average rent burden of 4%.

The unification treaty which resulted from the union of East and West Germany on 3 October 1990 created the institutional, legal and economic framework for a market economy, which was to include the housing sector.

Article 22(4) of the unification treaty made provision for the →*privatisation* of the formerly state-owned housing stock. The municipalities, as the initial owners of the previously nationalised housing stock, were given the task of integrating this property into the open market. This meant that the housing stock had to be managed and administered by privately-run →*enterprises*, which had to find private tenants or capital investors for it.

The Accumulated Debt Assistance Act made it easier for the housing companies to service national loans which had been granted by the GDR for new dwellings. The Federal Republic of Germany was the new creditor and partly waived the old loan repayments on condition that the companies agreed to privatise at least 15% of their housing stock.

The focus on a social but also market-related housing policy in the new states had to make allowance for the high average age and the disrepair of existing dwellings. As a result, the restoration of the housing stock was a political priority. This also meant that step by step, rents had to be increased.

There was an urgent need to mobilise private capital for investment in the construction of new dwellings in order to improve the quality and quantity of the housing on offer. The goal of the housing policy was the creation of a functioning housing market. To this end, the housing enterprises had to be aligned to the open market. But owner-occupancy also had to be encouraged.

The First and Second Ordinance on Basic Rent, the Housing and Rent Law Conversion Act and the introduction of a comparative rent system in 1998 created a social and market-related rent policy aimed at the transfer of state controlled rents into the comparative rent system of the open market. Thus the maximum rents were gradually increased with due consideration of income trends and the individually tailored assistance of special housing benefits. Rent restrictions on new, altered and modernised buildings had already been lifted in 1990. As a social safety net and to soften the impact of the rent increases, a Special Housing Benefit Act was introduced. This law also made it possible to complete urgently needed renovations of the housing stock in a socially acceptable manner.

An initial step towards promoting housing construction through tax benefits was the special regulations of the Development Areas Act, which were replaced on 1 January 1999 by the

Investment Subsidy Law. However, in some cases the considerable tax incentives offered by the Development Areas Act led to new dwellings being built more because of the tax relief than in response to market demand.

An important component of the housing policy in the new states was, and is, the broad support for private ownership of residential property, which was initially predominantly focused on newly built housing but now increasingly includes the existing housing stock.

In the new states, social welfare housing construction was predominantly used for the necessary investments into renovation and modernisation of the existing housing stock. This process was seen as an opportunity to avoid the structural faults of traditional social welfare housing, which were caused by the principle of renting at cost. It was largely possible to prevent mistakes in occupancy through the flexible arrangement of financial assistance. From the start, the construction of subsidised social welfare housing was of secondary importance in the new states.

Since the end of the 1990s, the new construction of social welfare housing has only been used in certain cases of urban planning when urgently required. Since the comparative rent system was introduced in 1998, supply has increasingly exceeded the demand (tenant market). Many dwellings are unoccupied, particularly in the economically backward regions, where up to 30% of the housing stock is standing empty.

On the one hand, the reasons for this have to do with the collapse of the economic base in these areas. There has been a population decrease due to job-

related migrations and a rapid decline of the birth rate. On the other hand, many private households have become owner-occupiers and have moved out of the cities into the surrounding countryside. The declining population trend was accompanied by the intense modernisation and building activities of the 1990s, with the consequence of a growing supply surplus.

Due to this development, from 1999 onwards there has been a reorientation of the housing policies of the →*Federal Republic, federal states and municipalities*. For a purposeful stabilisation and continued development of the housing market, the deconstruction or demolition of dispensable housing is undertaken on the basis of local urban development plans. This is how, in reaction to the changed demand, a future-oriented change of the cities is aimed at, and at the same time a balanced housing market on a long-term basis is secured.

This enormous challenge for urban planning and for the housing industry is supported with substantial subsidies by the federal government and regional states programme 'Urban Restructuring in the New Federal States'.

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**Housing policy:  
Old federal states (*Länder*)**

Cave, tent, house or skyscraper – shelter is a basic human need just like food, water and sleep. Nothing else can take its place. The need for shelter is paramount in every household at all times. Shelter is necessary for protection; it is indispensable for the survival of the individual and for that of social groups (families).

It had already become obvious in the 19th century that the housing market could not be left to its own devices. Industrialisation and the associated migration from the rural areas meant that the need for housing in the cities rose steeply. Land speculation, rent racketeering and homelessness were the consequence. Government interventions became necessary in order to preserve law and order and also for public health reasons. Outbreaks of epidemics among the poorer classes of society constituted a marked impairment of their working capacity. During this urbanisation process, minimum standards for housing construction were specified for the first time. This was also the time when the first self-help groups (housing cooperatives) came to life, and housing construction by the employer was one of the outcomes.

The universal housing shortage after the First World War was the reason for increased government interventions in the housing market. Numerous laws to combat the housing shortage were passed. These interventions developed into a system of 'government-controlled housing management' (which included tenant allocation and allocation control), which was practised until

the beginning of the 1960s. After the Second World War, nearly a quarter of the housing stock of some 18 million dwellings had been destroyed and more than 12 million refugees had to be accommodated. Providing the population with housing therefore became the government's priority.

A Housing Ministry at federal level was established. Further milestones were the First (1950) and the Second (1956) Law on Public Subsidies for the Construction of Low-Rental Apartments, which gave legal status to the three components of state intervention (government-funded social welfare housing, house building with tax relief and with independent funding). To this day, the Second Law on Public Subsidies for the Construction of Low-Rental Apartments forms the basis for the social housing policy, but it also provided the background for the family-orientated promotion of privately owned residential property.

The reduction of the housing shortages was accompanied by the  $\rightarrow$ *deregulation* of the housing industry and the gradual opening up of the housing sector to the open market. At that point, the transition from the allocation system that was appropriate after wartime to a market-orientated housing policy had been achieved. Subsequently, phases of strain and relaxation came and went. Today, in terms of numbers, the housing market is balanced, with the number of dwellings being roughly equal to the number of households.

This could lead to the conclusion that any form of government control has become superfluous. But is the housing market a market like any other? Can it be left to its own devices?

The answer is: yes and no.

Yes, because users and suppliers can exchange the commodity 'shelter' to suit their own tastes, freely, and for money, and because market prices tend to create a balance between the supply of usable living space and the respective demand. The special characteristics of this commodity do not change this (immobility, long life span, etc.). While they do cause problems in the housing market, they cannot bring it to a halt.

And no, because certain households are only insufficiently supplied with housing by the market, or even not at all. The latter occurs whenever households with small  $\rightarrow$ *incomes* have to spend a large proportion of their incomes on minimal shelter (distribution problem) and/or if certain social groups are discriminated against because of their specific characteristics (access problem). In a  $\rightarrow$ *social market economy*, the government has the task of providing a minimum of living space in the event of somebody not being able to do so for themselves (subsidiarity principle). Therefore, the housing policy has to address the distribution and access problems as a matter of priority. This means that the rent burden has to be tolerable for households living on a small income, and households belonging to the so-called 'problem groups' have to be given access to the housing market.

Besides these outstanding supply issues, the government as the implementer of the housing policy also stipulates basic conditions, which are supposed to ensure efficient interactions between  $\rightarrow$ *supply and demand* in the housing market, e.g. the Law of Tenancy. Finally, the private housing

property policy is usually subsumed under the housing policy, although its purpose is only marginally related to housing policy. Its main targets are →*family policy* and capital formation policy, as well as retirement provision.

According to Eekhoff, three sectors of practical housing policy can be differentiated in Germany:

### ***The social guarantee of housing***

The instruments which are used for the implementation of this social guarantee are housing benefits (distribution problem), social welfare housing and, more recently, the purchase of allocation restrictions for publicly assisted housing (both cases: access problem). Needy tenant and owner households receive housing benefits, which are also referred to as subject promotion. This enables them to rent or live in accommodation that is suitable for their family situation at market prices. The advantages of a housing subsidy are its flexibility, its social accuracy and fairness, as well as its efficiency because the preferences of the consumer are taken into account.

But housing subsidies do not solve the access problem. This in turn is achieved by social welfare house building, which is also referred to as object promotion. This starts with the housing supply and with investors in housing programmes who receive →*subsidies*. In return, they have to grant restricted allocation and reduced rents. The big problem here is that the social accuracy is significantly poorer than in the case of housing subsidies, since a considerable number of government-assisted dwellings are misallocated, i.e., they are not allocated to needy households. One

way out of this would be the purchase of allocation restrictions from the housing stock; the access problem would be solved. Housing subsidies which have become more important as instruments, take care of the social security issue. But so far, not much use has been made of the acquisition of allocation rights.

### ***Securing advantageous offers and conditions for use***

This includes the identification and development of building land, urban renewal and urban development measures, the Law of Tenancy as an instrument for the coordination of the interests of tenant and landlord (closely linked to the protection against unfair dismissal), as well as the tax law.

### ***Private residential property policy***

The promotion of owner-occupied accommodation is often strongly motivated by wealth creation criteria (home ownership grant), but in addition – in the context of social welfare housing programmes – it also serves specific housing policy objectives.

The Act on the Reform of Housing Construction Law which was passed on 1 January 2002, fundamentally reformed the housing law and initiated a new phase in the social welfare housing policy in Germany. The core of the law is the new Housing Assistance Act, which replaces the Second Law on Public Subsidies for the Construction of Low-Rental Apartments. Four elements play a central role:

- Focused assistance on those who are really needy (large families, low income).

- More consideration on the existing housing stock.
- Promotion of the acquisition of used residential property.
- Closer cooperation between housing policies and town planning.

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Winfried Michels

## Income

Income is the flow of goods (material income) or amounts of money (financial income) which a person, a household or an  $\rightarrow$ enterprise receives within a certain space of time from various different sources.

In the production process of an economy, income is generated as payment for the employment of the factors of production (labour, land, capital,  $\rightarrow$ production and supply). In return, the factors of production are remunerated with the factor incomes wages and salaries, rent and lease, interest and  $\rightarrow$ profit (wages and salaries as payment for work performed; rent and lease as payment for the supply of land or the temporary hiring of other capital equipment; interest in return for the supply of available capital, profit – or also loss –

as risk premium for the  $\rightarrow$ entrepreneur). The income distribution that results from this remuneration of the different factors of production for their contribution to the national income is the so-called ‘functional income distribution’.

Macroeconomically, the sum of these factor incomes corresponds with the national income, and thereby with the total value of all goods and services produced through the employment of the factors of production in a specific space of time (net national product to factor costs). The distribution of the income among the factors of production which arises from the economic production process is also called ‘primary income distribution’.

These factor incomes which are earned exchanging goods and services stand opposite transfer incomes. Transfer incomes are paid out to economic agents without (direct) returns on the basis of legal claims (e.g. pensions, retirement funds, unemployment pay), voluntary allowances from the state ( $\rightarrow$ subsidies) or other private economic agents.

After this rearrangement of parts of the functional income through transfers (and taxes), the primary income distribution becomes the secondary income distribution. This rearrangement is justified by the fact that social security is dependent on a ‘fair’ income distribution ( $\rightarrow$ social justice).

Despite all the differences of opinion (which even in the  $\rightarrow$ social market economy are still ongoing) on what can be considered as just (fairness of pay, opportunity or need), agreement exists that excessive inequality in income distribution must be avoided. For this reason, a progressively running income tax

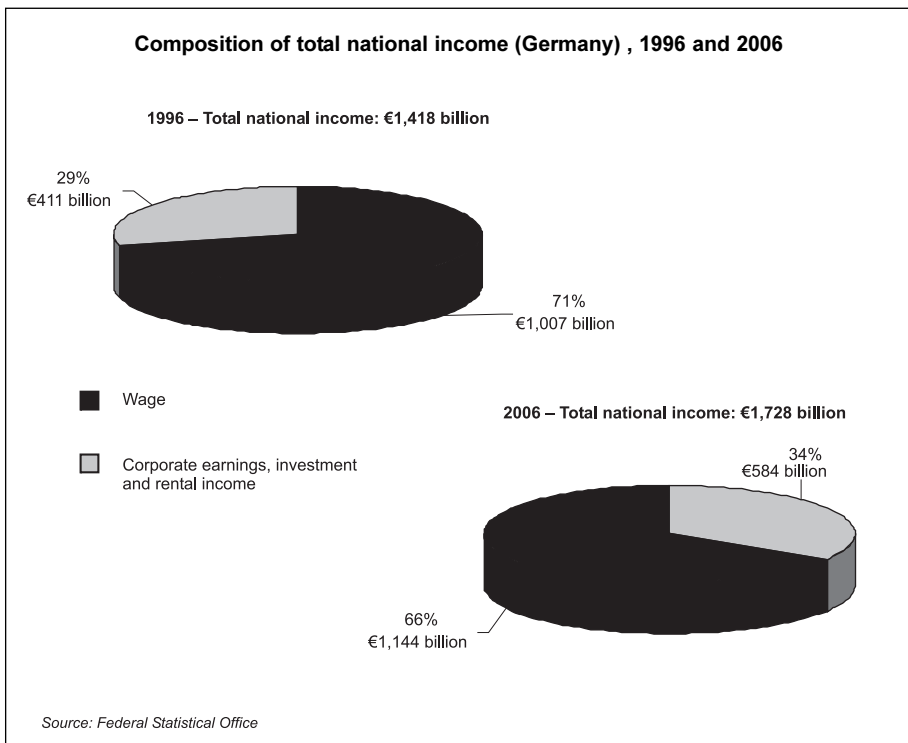
tariff which charges higher income groups proportionally more, is considered an equally integral component of the social market economy as support for those who are not capable of earning a functional income (sufficient). However, both measures can also lead to lower motivation to perform, or to be ready to perform, as well as to increased evasion into the  $\rightarrow$ shadow economy.

In order to examine questions of income distribution among population groups or individual subjects of the economy, the topic of functional income distribution has to be changed to personal income distribution. This considers the sum total of incomes of a group of economic agents (e.g. the private households or the self-employed) and takes into consideration the fact

that a household has both a wage income as well as incomes from other factors of production (e.g. investment income and rental income). Thus the personal income distribution is more appropriate as a starting point for the investigation of the income distribution and for the distribution policy in a national economy than the functional income distribution.

As a standard for the distribution of income in a national economy, the Lorenz curve is used (named after the American Max Lorenz, who introduced this form of representation in 1905). It shows which percentage of income-earners (abscissa) in each case receives which portion of the national income (ordinate).

A national economy where all economic agents receive the same income,



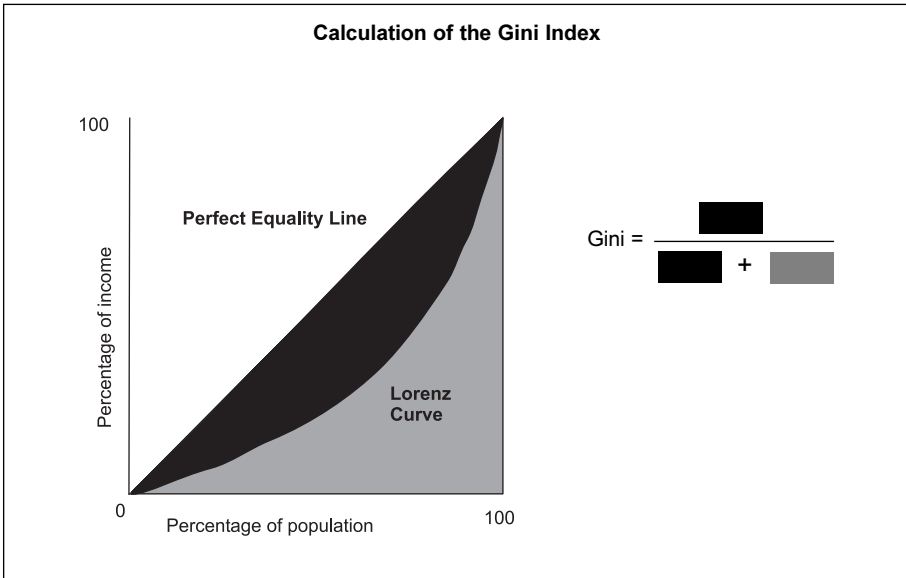
## Income equality: Gini Index of the last available year between 1985 and 2004

<i>Country</i>	<i>Gini Index</i>	<i>Country</i>	<i>Gini Index</i>	<i>Country</i>	<i>Gini Index</i>
Namibia	74.3	Nicaragua	43.1	Greece	34.3
Lesotho	63.2	Iran, Islamic Rep	43.0	Indonesia	34.3
Botswana	63.0	Uganda	43.0	Ireland	34.3
Sierra Leone	62.9	St. Lucia	42.6	Kazakhstan	33.9
Central African Rep	61.3	Kenya	42.5	Armenia	33.8
Swaziland	60.9	Singapore	42.5	Switzerland	33.7
Bolivia	60.1	Burundi	42.4	Yemen	33.4
Haiti	59.2	Zambia	42.1	Moldova, Rep	33.2
Colombia	58.6	Thailand	42.0	Sri Lanka	33.2
Brazil	58.0	Senegal	41.3	Belgium	33.0
Paraguay	57.8	Ghana	40.8	France	32.7
South Africa	57.8	Turkmenistan	40.8	Canada	32.6
Chile	57.1	United States	40.8	Tajikistan	32.6
Panama	56.4	Cambodia	40.4	India	32.5
Guatemala	55.1	Georgia	40.4	Bangladesh	31.8
Peru	54.6	Guinea	40.3	Korea, Rep	31.6
Honduras	53.8	Trinidad and Tobago	40.3	Romania	31.0
Argentina	52.8	Russian Federation	39.9	Netherlands	30.9
El Salvador	52.4	Tunisia	39.8	Luxembourg	30.8
Dominican Rep	51.7	Mozambique	39.6	Pakistan	30.6
Papua New Guinea	50.9	Burkina Faso	39.5	Kyrgyzstan	30.3
Mali	50.5	Morocco	39.5	Mongolia	30.3
Niger	50.5	Israel	39.2	Ethiopia	30.0
Malawi	50.3	Macedonia, FYR	39.0	Belarus	29.7
Gambia	50.2	Mauritania	39.0	Bulgaria	29.2
Zimbabwe	50.1	Jordan	38.8	Austria	29.1
Costa Rica	49.9	Portugal	38.5	Croatia	29.0
Mexico	49.5	Jamaica	37.9	Rwanda	28.9
Malaysia	49.2	Latvia	37.7	Slovenia	28.4
Madagascar	47.5	Vietnam	37.0	Germany	28.3
Nepal	47.2	Benin	36.5	Albania	28.2
Guinea-Bissau	47.0	New Zealand	36.2	Ukraine	28.1
Philippines	46.1	Italy	36.0	Finland	26.9
Uruguay	44.9	Lithuania	36.0	Hungary	26.9
China	44.7	United Kingdom	36.0	Uzbekistan	26.8
Cameroon	44.6	Estonia	35.8	Bosnia and Herzegovina	26.2
Côte d'Ivoire	44.6	Algeria	35.3	Norway	25.8
Venezuela	44.1	Australia	35.2	Slovakia	25.8
Ecuador	43.7	Spain	34.7	Czech Rep	25.4
Nigeria	43.7	Lao People's Dem Rep	34.6	Sweden	25.0
Turkey	43.6	Tanzania	34.6	Japan	24.9
Hong Kong	43.4	Poland	34.5	Denmark	24.7
Guyana	43.2	Egypt	34.4	Azerbaijan	19.0

Units: Index. 0-100; higher numbers indicate greater inequality

Source: *The World Bank: Development Data Group 2006*





would be represented by the bisector. An unequal distribution of the incomes leads to a downward curve. The further a distribution curve is positioned under the bisector, the greater the concentration of incomes.

As a measure of income concentration, the Gini coefficient is used. This relates the area between the bisector and the actual income distribution to the entire area under the bisector.

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*Jörg Winterberg*

### Indebtedness of developing countries

Indebtedness is shorthand for the economic and social problems that are associated with the rising foreign debt

and insolvency of many developing countries, particularly since the 1980s. The foreign debt is the sum of the public, publicly guaranteed and private long-term commitments, loans from the International Monetary Fund (IMF) and the short-term commitments towards private foreign creditors.

The reasons for the size and structure of the indebtedness are both internal and external. Internal reasons are to do with the specific circumstances in the debtor countries. These include particularly import and export dependencies due to deficient production, delayed adjustments to global economic changes, inefficient use of private and public foreign credits, and high public budget deficits. The high budget deficit is often as a result of civil war, the acquisition of arms and luxury goods, the absence of an adequate socio-political framework aimed at economic growth and social equality, and the lack of an economic policy focused on stability. Also to be considered here is the

flight of capital, legal insecurity and political instability, as well as the failure of those who are politically responsible (bad governance).

The developing countries are unable to influence the external causes of their indebtedness directly. Here, the key issues are trade restrictions for industrial goods and services and the agricultural protective system of the industrialised countries, falling world market prices for important raw materials, worsening terms of trade (the relationship of the prices of export goods to those of import goods) in the developing countries, and rising interest rates in the international financial markets.

The high foreign debt was followed by rising debt service ratios (debt serv-

ice in the form of interest on credits and repayments as a percentage of the export revenue) and thus by an acute debt crisis in many developing countries. High and rising liabilities arising from bilateral and multilateral development aid and trade loans coincided with falling foreign exchange proceeds and led to international insolvency (e.g. the temporary termination of payments by Mexico in 1982). In many countries, the annual debt repayments exceeded the export revenue. These heavy debts were putting economic growth and poverty reduction at risk.

In order to solve this debt crisis, the international financial institutions embarked on crisis management (the International Monetary Fund [IMF],

**External debt of Heavily Indebted Poor Countries (HIPC) in 2005**

<i>Country</i>	<i>% of GNI</i>	<i>Total in current US\$ millions</i>	<i>Country</i>	<i>% of GNI</i>	<i>Total in current US\$ millions</i>
Benin	43.5	1,855	Madagascar	69.6	3,465
Bolivia	71.3	6,390	Malawi	155.6	3,155
Burkina Faso	39.6	2,045	Mali	58.5	2,969
Burundi	169.4	1,322	Mauritania	119.1	2,281
Cameroon	43.6	7,151	Mozambique	82.3	5,121
Central African Republic	74.3	1,016	Nepal	44.3	3,285
Chad	36.8	1,633	Nicaragua	107.3	5,144
Côte D'Ivoire	68.7	10,735	Congo, Rep.	150.8	5,936
Congo, Dem. Rep.	156	10,600	Rwanda	71.3	1,518
Eritrea	76.5	736	Senegal	46.9	3,793
Ethiopia	56.2	6,259	Sierra Leone	144.9	1,682
Ghana	63.6	6,739	Sudan	72.1	18,455
Guinea	100.2	3,247	Tanzania	64.4	7,763
Guinea-Bissau	239.6	693	Gambia, The	64.4	672
Haiti	31	1,323	Togo	78.8	1,708
Honduras	65.9	5,242	Uganda	52.2	4,463
Kyrgyz Republic	86.1	2,032	Zambia	83.3	5,668
Liberia	591.4	2,581			

Total Population of HIPC: 554 million  
Source: Worldbank, World Development Indicators (WDI) 2007, Table 4.16 External debt

the World Bank and the regional development banks), with the granting of new loans to the principal debtor countries being made conditional upon growth promoting structural adjustment programmes (the Baker Plan).

Since 1989 indebtedness began to be seen less as a liquidity problem than an insolvency problem, which the commercial banks and the governments of the creditor countries tried to resolve by writing off a large proportion of the debts and/or the debt service (the Brady Plan).

The new restructuring programme drawn up by the IMF and the World Bank takes all creditors' claims into account and contains transparent, uniform rules about how and through which steps transformation and reform processes in the insolvent countries justify a reduction or cancellation of their debts – as well as which criteria should be used to determine a level of 'tolerable' indebtedness. This formed the background of the World Bank and IMF Heavily Indebted Poor Countries (HIPC) I initiative in 1996 for the most seriously debt- and poverty-ridden countries, and from 1999 for the extended HIPC II initiative.

The new feature here is the link between debt reduction and the fight against poverty, which means that the poorest countries can decrease their debts through national Poverty Reduction Strategies (PRS). These strategies have to be drawn up, implemented and kept up with positive results for one year under the involvement of broad sectors of the population (the principle of country ownership). In addition, three-year structural adjustment programmes have to be undertaken.

Furthermore, the criteria for what is considered tolerable indebtedness for HIPC have been lowered. (A debt-service ratio, expressed as the proportion of the annual debt service to the export revenue, of no more than 15% and current total debts of no more than 150% of the annual export income.)

The HIPC group includes 42 countries, predominantly in Africa; in 1996, their total foreign debt amounted to approximately US\$245 billion. At the Cologne G-8-Summit in 1999, it was agreed that in the context of the HIPC initiative, debts to the value of up to US\$70 billion would be cancelled. By September 2003, 27 countries which had become eligible for debt cancellation and whose debts in 2002 amounted to US\$77 billion had already had US\$32 billion written off. In relation to 34 countries of the HIPC group, the cancellation of debts would amount to a total of US\$40 billion.

For many HIPC, however, indebtedness remains the key problem in their economic and social development, so much so that the World Bank and IMF consider that more debt cancellations ('topping up') is necessary.

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Ronald Clapham

## Individual responsibility

Individual responsibility means that everybody is personally accountable for his/her actions and for the consequences which result from those actions.

### *Individual responsibility within the sphere of free market activity*

The principle is universally accepted in those cases where an action and the consequence of the action are closely interrelated. Examples are direct injuries of the right to freedom of others and the fulfilment of contracts: someone who violates the personal freedom of another is adding non-material damage (damage to reputation) to material damage (property damage) or physical damage (bodily injury).

Here, it is a fundamental legal principle that perpetrators are responsible for the damage they have caused and are therefore required to make amends. Likewise, it applies that someone who has entered into a contract is basically responsible for the fulfilment of the contractual obligations. If not, the other contracting party can claim compensation.

In other areas, however, the connection between action and consequence of the action is less obvious. This is the case above all when a market participant suffers a loss of income without being conscious of being at fault. Here, too, the principle of individual responsibility applies.

When it comes to choosing an occupation, some individuals will decide in favour of independence while others will prefer to work for an employer. Yet deciding to embark on a particular

career or another does not mean that a certain  $\rightarrow$ income is permanently guaranteed. It does not even mean that the income depends exclusively on one's own conduct. It is true that the bankruptcy of an entrepreneur who through negligence allows infrastructure to become outdated or who does not carry out adequate cost controls is seen as being at fault. But it is equally possible that he/she is pushed out of the market through no fault of his/her own because new competitors with innovative, patented products have entered the market ( $\rightarrow$ open markets: market entry, market exit).

The situation is similar regarding the employee. Employees may be made personally accountable for their dismissal due to dereliction of duty on the job. This does not apply if despite diligence and commitment they are dismissed because the employer is cutting jobs due to rationalisation, or is going into liquidation.

In the relationship between performance and success, besides individual knowledge and abilities, many imponderables, as well as coincidence, play an important role. In a  $\rightarrow$ market economy remuneration does not exclusively depend on the performance and personal commitment of the entrepreneur or employee, but on an anonymous evaluation of their performance by the market.

In the event of the  $\rightarrow$ entrepreneur or the employee losing their occupation through no fault of their own, generally no one else can be made accountable. An employment contract does not guarantee permanent employment; not for the employer and especially not for third parties, for instance, the business

partners of the employer. Therefore each person has to carry the consequences of his/her economic actions even if his/her efforts have failed through no fault of his/her own.

Since those who are directly affected – the entrepreneur's new competitor or the employee's employer – cannot be forced to make amends, one could say that it was up to society to save the enterprise or the jobs from destruction. But this is also wrong. Society can only make good for the failure of individuals by distributing the resulting burdens among the rest of the people – because they are not prepared to do this voluntarily, it has to be done by force. This sort of force is, however, an inadmissible interference with personal freedom. It follows that the individual liberty of all citizens in all its aspects can be upheld only if it is connected with an equally all-encompassing responsibility for one's own fate. Thus, in the free market system individuals have to carry the consequences of their economic actions even if they are not to blame for the failure of their efforts.

### ***Consequences of the collectivisation of accountability***

For a society in which the citizens can relinquish their individual responsibility to the community, there will be consequences in the long term that go far beyond the violation of the right to personal freedom which is present in each individual case.

First, due to the continued shifting of responsibility on to society, personal liberty in the society is displaced more and more by the power of a social collective, which has to deprive people of their liberty to the same extent to which

it takes on their responsibility. Second, people will increasingly expect others to take care of specific problems. People become less and less prepared, or even forget, to take on responsibility.

The striving for individual irresponsibility thus not only leads to a displacement of responsibility in the community but in this way in the long run also to its removal. In the long term, this leads to the destruction of the foundations of a free social system and, concomitantly, of the social market economy. A society whose members feel neither responsibility for themselves nor for the community cannot survive.

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*Lüder Gerken*

## **Industrial action**

Bargaining autonomy, which rests on the constitutionally enshrined freedom of coalition, will function only if something close to a balance of power (counterweight principle) exists between the trade unions and the employers' associations in their capacity as bargaining partners.

Since collective bargaining is both about common goals (such as the preservation of competitive ability, particularly with regard to the allocation of →*profit* to the factors labour and capital) and also about diverging interests, both sides must have an equal chance to gain

the upper hand without one side being in a position to dictate to the other. Strikes or lockouts can help in bringing about an acceptable compromise if all else fails.

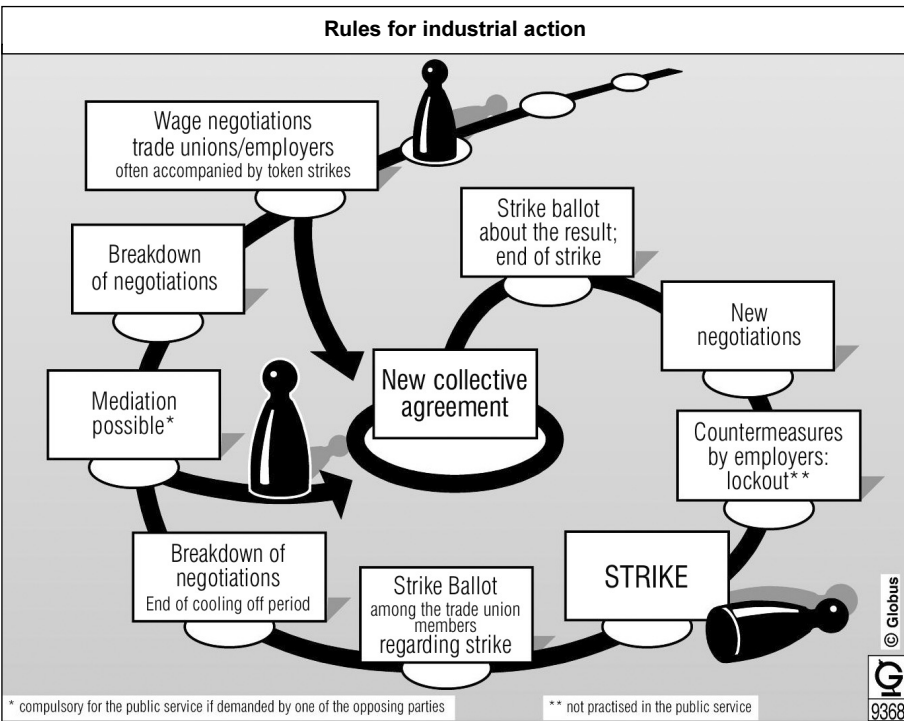
A strike is defined as an organised collective downing of tools by either a part or all of the workforce for the purpose of forcing the employers, through the losses incurred, to give in to the union's demands. The employer or employers concerned can react to this confrontational measure with a lockout. This entails closing the business and temporarily halting the payment of wages and salaries. Thus, on the union side, the threat potential consists in the withdrawal of the workforce, while on the employers' side it rests in the refusal of wage payments.

During labour disputes the employee-employer relationship becomes

dormant and resumes its existence thereafter (suspending effect). In practice it is first and foremost the trade unions which depend on the right to strike, since they, as a rule, make the demands. Without it, acceptable →collective agreements would not be guaranteed.

Before making use of the labour dispute instruments at their disposal, union leaders are obliged to hold a so-called strike ballot and to take the readiness of their members to strike into account. But the union leaders also have to consider the economic consequences, since they are liable for the payment of so-called strike benefits in lieu of their members' wages.

In order to achieve their aims as easily and quickly as possible, trade unions are eager to stage labour disputes only at the most sensitive times and places in



\* compulsory for the public service if demanded by one of the opposing parties

\*\* not practised in the public service

the production process. With increasing production dependence on deliveries of manufactured components, the scope for industrial action has widened considerably. The expansive enforcement strikes that used to be quite frequent – often countered by blanket lockouts from the employers' side – have now largely been replaced by relatively brief and geographically limited point strikes. This notwithstanding, Germany, together with Austria and Switzerland, has one of the lowest strike frequency rates in the world.

Since labour disputes can inflict great losses on the economy and may be the reason why delivery agreements are not kept, the readiness of the →*social partners* to compromise has extreme significance for the international competitiveness of a country. Nevertheless, contrary to most other industrialised countries, the right to engage in labour disputes is not legally regulated in Germany. Instead, the legal framework around actual labour disputes consists of action guidelines that are often vague and based on decisions taken in specific cases in the Federal Labour Court and in the Federal Constitutional Court.

Over the years, this way of updating the code of law through so-called Judge's Law has changed direction many times. In the 1950s and 1960s, for instance, the Supreme Court held that labour dispute action should only be the last resort after all possibilities for negotiation had been exhausted (*ultima ratio* principle). Today's jurisdiction by contrast tends to consider token strikes of limited duration and participation, running concurrently with negotiations, as more conducive to the swift conclusion of a new collective agreement.

The existence of a collective agreement that is either still in force or has been reinstated is the only scenario where no labour dispute measures may be taken (obligation to keep the peace), but even in the case of so-called wild-cat strikes, staged while current collective agreements are still valid, judicial decisions are often ambivalent. In any event, the interpretation of the law which considers strikes to be an integral part of the bargaining autonomy also believes that they should not be used to promote general political goals but only in the specific context of trade union agreements.

Furthermore, labour dispute measures have to take place fairly and should only target those who are directly involved. Political strikes and solidarity strikes are therefore absolutely forbidden. Likewise, the extent and intensity of the respective labour dispute measures must be appropriate (principle of social appropriateness).

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## Industrial policy

The term 'industrial policy' has never been clearly defined, which means that it is continually exposed to heated political and scientific debate. What all attempts at a definition have in com-

mon, however, is undoubtedly the fact that industrial policy refers to the implementation or omission of government interference with the functioning of the industrial sector in a market economy ( $\rightarrow$ *interventionism*). In this sense, industrial policy is the sum of all government measures that result in the politically intended organisation of industrial structures.

Even in a  $\rightarrow$ *market economy*, interference with the market process represents an important field for economic policy activities. If the objective of an economic policy is to increase overall economic welfare, then the industrial policy must optimise the contribution by the industrial sector to the total welfare.

The scientific demarcation of the term is also difficult because a definition of the industrial sector is not without its problems. This is due to the increasing overlap between the three economic sectors of agriculture, industry and services. The differing interpretations are therefore located anywhere between a  $\rightarrow$ *structural policy* with its point of reference in industry (secondary sector) and the inclusion of all government interventions (inclusive of the primary and tertiary sectors), aimed at manipulating the development of industrial structures which have resulted from market processes.

There is a large variety of practical measures that can be used to this end. Examples are  $\rightarrow$ *subsidies*, tax rebates, government investments (government commissions), material or non-material business start-up assistance and secured loans. These instruments which distort the results of free competition are generally referred to by economists as 'process policy' actions. This tends to

make them the main target for the criticism of liberal economists.

Without necessarily focusing on the individual branches of industry, industrial or structural policy essentially can focus on the preservation, adjustment or organisation of industrial structures. These goals are inherently different in character. Structural preservation and structural adjustment are described as passive or defensive policies; structural organisation, by contrast, as an active or offensive policy.

At least implicitly, against the background of increasing unemployment, the required political interventions are largely implemented in the hope of saving existing jobs or creating new ones. The efforts to preserve declining or shrinking industries – possibly due to a special regional significance or in the attempt to gain autonomy (agriculture, coal mining) – make this immediately clear.

The policy of structural adjustment, however, is supposed to facilitate the necessary structural transformation of the economic production processes (e.g. privatisation within the areas of telecommunication and electricity). The organisational part of industrial policy is meant to go further by identifying potential growth sectors and by providing these very sectors with the available resources (space travel, biotechnology).

One is equally forced to concede that the preservation of industries – as desirable as this may happen to be from a regional perspective – ties up resources in shrinking industries in the long term, which are then not available for growth industries that have evolved from the market itself. Declining



growth and job losses are the immediate consequences, mostly without being recognised as such. This criticism also concerns adjustment grants. Originally conceived as temporary measures, they have a habit of becoming permanent. It is extremely difficult to terminate assistance, once approved, against the will of the recipients (subsidies for theatres or orchestras; agriculture).

Efforts to focus on the promotion of specific so-called growth industries are faced with the evolutionary character of the economic process. The tangible successes of competitive markets tend to have resulted from a multiplicity of individual decisions and definitely not from central planning on the basis of a politically motivated target. This makes a reliable medium- or even long-term forecast of concrete competitive results impossible.

It follows for this reason that structural organisation policies usually have to resort to what seems plausible, thereby running the risk of false estimates which can lead to the squandering of limited resources. In addition, the selective promotion of individual industries is associated with the discrimination of industries and enterprises that are not subsidised.

Even in a  $\rightarrow$ social market economy, industrial and structural policy has to take the evolutionary character of competitive processes into account. It should therefore be content with creating an environment conducive to growth and employment (infrastructure, a competitive system under the rule of law, the guarantee of private property and freedom of contract).

One of the important characteristics of the social market economy is a cer-

tain measure of solidarity. This makes it a crucial task to help those who are temporarily or permanently, not yet or no longer, able to succeed in a competitive environment. This, however, cannot be the task of the industrial or structural policy, as the social market economy does not want to endanger the basis of a redistribution in favour of this group of people. Assistance for economically weak individuals is the responsibility of a  $\rightarrow$ social policy (minimum income, government transfers in the form of subject promotion) and not of an industrial policy.

Industrial policy has to serve to create the necessary conditions for an optimal allocation of resources across the market under equal conditions for all economic agents, without interventions in the economic process by the state.

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## Industrial relations constitution

Germany's Industrial Constitution Law (*Betriebsverfassungsgesetz*) regulates relations between the employer and the employees of a business. The staff is represented by the works council, which has institutionalised participation rights. The Industrial Constitution Law applies to enterprises with at least five permanently employed employees. The size of the works council depends on the number of employees; while part-time workers are taken into account, members of the executive staff are not. Workers and employees must be proportionally represented on the works council.

Works councils with more than nine members (in companies of over 300 employees) constitute an operating committee that deals with current business. In companies with several branches, a total works council is to be formed. Within a company with legally independent →enterprises, a company works council can be established. There are special representation bodies for young people and trainees in companies with at least five trainees or employees under 18 years. In companies where at least five severely disabled persons are on the staff, this group selects a shop steward.

The Industrial Constitution Law applies only to companies that are constituted under private law; for the public service, the Personnel Representation Law applies. In enterprises that are focused on, for example, political, charitable, religious or educational objectives, the rights of the staff representatives are limited.

The Industrial Constitution Law does not entitle staff to become

involved in economic and business decisions. The powers of the works councils are limited to the legally designated areas. Apart from the right to information there are special nomination, hearing and consultation rights. Nomination rights refer to personnel planning and the promotion of professional training. Hearing rights are granted in situations of notice being given by the employer.

Consultation rights are granted in respect of personnel planning, professional training and the layout of the workplace, and before planned operational changes. In some circumstances specified by the law, the works council has genuine rights of →*co-determination*. These concern above all the regulation of working hours, the manner in which remuneration is paid, vacation planning, the use of technical equipment and health and safety issues.

Apart from informal agreements regarding regulations, works councils and employers can also sign written employment agreements. Like collective agreements, employment agreements apply directly to all employees; individual contractual deviations are permissible only in favour of the employee. Employment agreements can regulate all operational affairs, as long as there are no legal obstacles. Collective agreements are given preference over employment agreements. The parties to a wage agreement can, however, specifically authorise differing employment agreements.

Works councils are not authorised to participate in business decisions; only proposed operating changes with substantial disadvantages for the staff may be discussed. In such a case, the works

council can insist on a social plan intended to moderate and alleviate the economic disadvantages for the employees.

A works assembly has to be scheduled by the works council at regular intervals; it only serves for information and debate. The same applies to the youth and trainee assemblies, which – in contrast to the works assembly – are not mandatory.

For companies that are active in several member states of the European Union, an EU guideline envisages the implementation of a European works council. However, a voluntary agreement on the implementation of a European worker representation council has priority over a legally formed European works council, which will be constituted only if a negotiated solution between employees and employers fails.

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Gernot Fritz

### Institutional economics

Institutional economics concerns the way in which institutions restrict human actions. Institutions are defined as long-term contracts, organisations, formal rules such as laws and constitutional regulations and informal rules that are not tied to a specific form such as ethics, customs and habits.

Among the forerunners of the contemporary 'new institutional economics' are the older American institutionalism, the German historical school and ordo-liberalism. Within the new institutional economics there are different areas of research, of which the principal-agent theory, the governance cost theory, the property rights theory (which includes a legal analysis) the public choice theory, constitutional economics, as well as the history of the economy and its institutions are the most important. A brief discussion of each of these areas follows.

Modern economic systems are based on a greatly differentiated division of labour. For almost any task there is a specialist who has the ability, inside a closely limited area of expertise, to solve the most difficult problems. In other areas, however, he/she usually has only little know-how or none at all. This is why a large number of specialists are involved in the production of goods, e.g. cars. Their cooperation has to be well organised in order to result in goods and services that can hold their own against the →*competition*. There are actors participating in such cooperation who initiate the realisation of projects, and others who are appointed to see the projects through. In economics, the former are referred to as principals, the latter as agents.

A fundamental problem consists of the fact that a principal can achieve a high-quality production only if the agent's work meets the standards of the principal. This is a serious practical problem because the principal cannot supervise the agent perfectly. On the one hand, he/she cannot do this because gathering information is expen-

sive in itself. It requires time, which is then no longer available for other things. But even if the principal was able to see everything the agent gets up to, he/she would still not always be able to judge the activities correctly.

If we observe, for example, engineers at work we still don't know whether they are doing their work well or not. The agent tends to be better informed because in practice the gathering of information, negotiations and supervision cost money – the so-called transaction costs. He/she can use this to the principal's disadvantage.

That is, for example, the case if managers who are also agents tell the shareholder-principals that they require an enormous budget as well as several secretaries and company cars, although the quality of their work would not suffer if they had only half the amount of equipment. This in turn can lead to projects not being carried out, although they would benefit both the principal and the agent because the principal does not want to run the risk of being exploited.

Against this background, the *principal-agent theory* is concerned with the question of how contracts can be arranged in such a way that the agent is motivated by the kind of remuneration or other incentives to carry out tasks to the principal's satisfaction.

The *governance cost theory* relates to a similar issue – mainly contractual and organisational solutions which help to secure investment projects. When certain investment projects are put into practice, it is quite common that one of the partners to the deal has to specialise. That means that he/she contributes something to the investment project

which is of immense importance to the specific project, but which is of little value for anything else.

In an extreme case, he/she may re-equip his/her entire machinery to ensure that the manufacture of a certain large order can be completed on time and satisfy the agreed quality standard. Clearly, this kind of special effort is worthwhile only in the case of an exceptionally profitable project. But even then there is the risk that a partner is exploiting the specialising trade partner. The partner is obviously aware that the specialisation has led to a dependence and will gradually try, through skilful negotiation, to turn this to his/her advantage. If, however, the specialising trading partner suspects such exploitation practices, he/she will demand securities or he/she will in extreme cases reject participation in the project. In this case, an investment, which would in theory benefit everybody, is not actually made at all.

Against this background, the governance cost theory deals with ways of defusing, through skilful contract design or organisational changes, the dangers of exploitation inherent in specialisations which have been discussed so that investments can be made relatively safely and to mutual advantage.

As well as contracts and organisations, legal regulations also serve to secure productive exchanges. It is only the existence of reliable rules that enables people to sign mutually beneficial contracts. Absolute freedom – a state of anarchy in which everyone can do what he/she wants – is just as unproductive as comprehensive central planning, which gives the individual no space whatsoever.

Progress in the form of new products and procedures, which the consumers demand, can come about only if the law guarantees free and fair competition. 'Fair' in this case means, on the one hand, that the state provides acceptable rules relating to competition (monopoly and antitrust law) and, on the other, that the competitors are restricted to the use of such instruments that do not have unwanted repercussions for third parties (so-called externalities).

**Property rights theory** and the economic analysis of the law deal with questions such as how the rights of action or disposal should be organised for the participants in order to eliminate or reduce externalities effectively and economically. Competition prevails not only on goods markets but also in the political sector. Here, the question whether the competition between politicians and other public servants (the political agents) leads to the results which the citizens (the principals) desire, equally depends on the institutions.

**Public choice theory** (the theory of public decision-making processes) has helped to make it clear that politicians do not automatically act as servants of the people, but that they need to be motivated to represent the will of the people through democratic control and other incentives.

**Constitutional economics** concerns itself with the next question, which is how productive (constitutional) restrictions for political agents should be implemented. **Institutional economic history** assumes over time institutions go through different phases, affecting the prospects of profit-yielding innova-

tions considerably. If the social institutions are such that innovations and investments appear worthwhile to the experimenting participant, the number of technical innovations in a society will rise. Exactly the opposite is the case if there are no financial incentives for the potential innovator to convert ideas into innovations due to the nature of the social institutions.

Apart from this theory, the **economic history** of institutions examines the question of how differently formal and informal institutions (written laws and unwritten ethical rules as well as customs and habits) adapt to changing conditions of scarcity and how prosperity is affected by such changes.

Although these areas of institutional economics are based on different epistemological concepts, they share the assumption that economic agents are greatly affected by their institutional environment.

Institutions reduce transaction costs, create safe expectations and enable the economic participants to benefit from various commercial advantages. This makes the improvement of the institutional framework, both economically and politically, an ongoing task of the highest urgency.

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### **Institutional order policy (*Ordnungspolitik*) and process policy**

Economic policy is the generic term for all state activities implemented in order to organise and control (or to steer) the economy in line with political objectives. A distinction has to be made between two areas of economic policy: institutional order policy and process policy.

Institutional order policy aims at achieving the desired economic order. To this end, a general institutional framework has to be put in place to coordinate all the individual economic activities in such a way that an economically integrated process results, which will produce the best possible outcome for society as a whole. The economic processes themselves and their results are influenced and controlled by process policy.

An economy which depends on a highly specialised division of labour cannot survive for long without an organised order. At the same time, there is considerable room to manoeuvre when it comes to the actual detail of the institutional order policy. Over the past several decades, these have been exploited in practice with uneven results (such as the socialist central planned economies in the Soviet Union and East Germany [GDR], the competitive  $\rightarrow$ market economy in the United States and the  $\rightarrow$ social market economy in West Germany [FRG]).

In decentralised, competitive market economies, the main task is the creation of a good economic system (order): the economic order should run smoothly and benefit society as a whole

without requiring many process policy interventions. Process policy interference with the market process ( $\rightarrow$ interventionism) should take place only if the self-regulating forces of the market are either not functioning at all or only partially functioning, meaning that  $\rightarrow$ competition between suppliers and buyers is not yielding the results expected by society.

The concept of the  $\rightarrow$ social market economy sees a need for process policy measures to correct market results which are not in line with the socio-political goals of society (such as income redistribution in favour of groups of disadvantaged persons, interference with the pricing of health services,  $\rightarrow$ social policy).

Institutional order policy-makers are called upon to create a solid system of rules – preferably embedded in the legal system and applicable and, if necessary, enforceable in the economic process – and to arrange them into an appropriate legal framework. Institutional order policy gets to grips with the nitty-gritty of the way the economic process should be planned and coordinated, but it is also responsible for the constitutional status of private property, budgets, enterprises and markets. Furthermore, it deals with detailed aspects of the  $\rightarrow$ financial constitution, the  $\rightarrow$ monetary order as well as the increasingly important foreign trade institutional framework.

In addition, in a social market economy, the institutional order for social security plays an important role. The main responsibility for shaping a well-conceived economic system (order) is the legislative power. Since institutional order policy interventions have a signif-

icant impact on the quality of the economic system, the different measures ought to be designed for the long term, thus putting planning on a firm foundation. Frequent and sudden changes of these fundamentals that matter to the economic agents make planning more difficult and confuse investors.

Process policy, however, interferes with the economic processes at the heart of the established economic order. Areas where process policy actions might be implemented are goods or factor markets, as well as specific industries (such as mining, agriculture) or the entire economy (such as price levels, →*employment*, income distribution).

The main actor in process policy is the executive (governments, authorities, the central banks, monopoly commissions, etc.), which seeks to influence processes and their outcomes in the short or medium term, for example, through market price fixing, changes to taxation and interest rates or transfer payments. Frequently, however, these process interventions lead to distorted factor allocations and unwanted process results, which in turn make new interventions necessary (intervention spirals).

Concrete examples of institutional order policy measures are the creation of an autonomous central bank which is largely independent of political decisions, the introduction of →*occupational health and safety* laws, the abolition of the law regulating trading hours or new legislation on an environmental tax reform.

Examples of process policy interventions are the amended regulations regarding the different ways of obtaining tax relief on investments, permission to trade on Sundays, the variation

of the municipal factor of business tax or a temporary driving ban during smog.

In its practical application, economic policy does not always make a clear distinction between institutional order policy and process policy, because economic or social policy goals can be attained either through the implementation of a general institutional framework or through direct process interventions. However, when dealing with economic decisions and their practical consequences, it must also be remembered that the growing number of process interventions is usually accompanied by more and more government directives and red tape. This leaves less room for individual economic decisions, possible innovations and the sort of flexibility that is characteristic of successful market economies (→*market economy and public institutions*; →*interventionism*).

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### **Institutional order policy (*Ordnungspolitik*): Exemptions from competition rules**

In a market economy, the government has the important responsibility for

drawing up a code of general rules for the market participants. Within this institutional order framework, all the economic agents have their own agendas and take action accordingly. The decentralised coordination of all this individualised planning occurs by way of the market price mechanism, while the competitive process ( $\rightarrow$ market mechanism) keeps the market participants in check. But in all free market systems there are a number of economic sectors that require special regulations because they deviate more or less strongly from these general basic principles. Such sectors exempted from general competition rules continue to be a feature of the German  $\rightarrow$ social market economy.

Agriculture is a classic example. Every year, the European Union ministers of agriculture agree on intervention prices for the European agricultural commodities markets. In addition, certain agricultural products are subject to fixed production limits or quotas ( $\rightarrow$ agricultural policy). In certain cases, German farmers are entitled to run cartels and fix prices and trading conditions vertically (with suppliers or customers), despite the fact that this is in principle not allowed in Germany.

Further areas exempted from competition include network-based sectors of the economy such as the public electricity supply, water supply, railways, post office and telecommunications. Here, market newcomers generally require an official permit to operate as network or service providers. More or less the same thing applies in most of these sectors with regard to the way enterprises determine their prices. Further special regulations in other areas of the economy that encompass

everything from medicines to the free professionals could be added.

All these special provisions constitute breaches of market and competition regulations. Government interventions render market price mechanism either totally or partly ineffectual; this is generally known as state intervention ( $\rightarrow$ interventionism) and means direct control of the economic activities in certain sectors of the economy by government institutions or their representatives. Important examples are state regulations controlling market entry ( $\rightarrow$ open markets), prices, production and sales volumes, investments and capacities, as well as quality and terms.

Legal exemptions from the ban on cartels and special competition policy regulations should not be classified as measures of government regulations. They are instrumental in releasing certain sectors of the economy either entirely or partially from the general regulations of the  $\rightarrow$ Act Against Restraints of Competition. The partial exemptions refer to the following regulations or prohibitions of the Act Against Restraints of Competition:

- the prohibition of cartels and price fixing;
- the ban on price recommendations; and
- monitoring of abuse in cases of exclusivity commitments of customers towards certain suppliers.

The economic sectors currently enjoying these privileges include the water boards, agriculture, the finance and insurance industry, copyright com-



panies and the sports sector. If the state is prepared to issue area-restricted exemptions that grant special permission for private restrictive trade practices while they are prohibited in the remaining areas, then a direct, governmental restraint of competition is the consequence of selective special permissions.

Industry characteristics are cited as the official justification for competition policy exemptions. Reference is made to characteristics of the respective enterprises, production processes, goods or marketing conditions. Critical examination reveals, however, that in the majority of cases the listed characteristics do not represent a sufficient reason for special government regulations and exemptions from antitrust regulations.

A deeper economic analysis is more convincing. Special exemptions from competition rules are justified only if genuine malfunctions of the competitive market process arise in the form of market or competition failure. Market failure occurs when the coordinating mechanism of the market fails to kick in, such as when prospective buyers of certain goods (public goods) are not prepared to pay a price, with the result that the producers cannot replace their expenses ( $\rightarrow$ public expenditure;  $\rightarrow$ public enterprises). Competitive failure occurs when the competitive process leads to a deterioration of market results (such as in the case of natural monopolies or destructive competition).

A detailed economic analysis shows that the greater proportion of special governmental regulations which existed in the early 1990s in Germany failed (in the areas of telecommunications, the

post office, the railways, grid-based power supplies) and almost all antitrust exemptions were unjustified.

In order to be able to answer the question why economically unjustified special regulations are introduced and allowed to remain in place, one has to look to the  $\rightarrow$ 'new political economy'. If one assumes that there is a market for special arrangements where politicians as suppliers and entrepreneurs with their employees act as customers, then one will understand why special regulations exist. They particularly depend on variables such as the type of entrepreneur (innovative, passive), cost and supply, the type of market (many or few market participants), market phases (growing, saturated markets), as well as authority structures ( $\rightarrow$ interest groups, lobbies). But the theory also explains why since the middle of the 1990s a large proportion of the failed special regulations and antitrust exemptions in Germany have been abolished.

Considered in detail, it becomes obvious that economic losses alone will not make the  $\rightarrow$ deregulation of unjustified special regulations politically acceptable. Further decisive factors have to be present, such as European  $\rightarrow$ integration,  $\rightarrow$ globalisation or certain technological innovations. But concomitant with the process of deregulation, which will not be complete for a long time to come, there have been plausible macroeconomic calls for new regulatory bodies (re-regulation). These are expected to be helpful in forcing market openings in certain network industries (telecommunications, post office, railway, power supply), and in stimulating competition in the secondary markets by means of non-dis-

criminatory network-user prices and conditions. This shows that the institutional policy on special regulations does move in just one direction.

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Norbert Eickhof

## Integration

Economic integration is defined as the opening of national economies to transnational cooperation with other countries, mostly in the same region. The intergovernmental agreement is characterised by the fact that international trade intensifies (trade creation) and that the exchange of goods and services with third states (non-integrated states) is redirected in favour of the members (redirected trade).

Another consequence of the integration of national economies is the fact that short- and long-term capital movements between the countries increases markedly. Provided the necessary institutional and legal framework has been put in place, integration also gives workers more mobility and facilitates the exchange of commercially protected and economically useful knowledge.

Due to the harsher  $\rightarrow$ competition in a much larger market,  $\rightarrow$ enterprises in the member states are encouraged to stay at

the forefront of technical progress, to improve their management efficiency and to acquire the knowledge they need to supply more foreign markets.

Critics of such agreements, however, see the danger that the participant states cut themselves off from the rest of the world and obstruct the international division of labour. If this happens, global market prices lose their function as indicators for the factors of production; retail prices tend to be higher than those in comparable international markets, in order to protect products that are globally no longer competitive. For this reason, regional economic areas are expected to adopt a liberal trade policy (open trade with third states), which simultaneously promotes their integration into the world economy.

Integration and the  $\rightarrow$ social market economy complement each other. Markets that are opening up and prices and markets that are becoming more realistic due to competition ( $\rightarrow$ open markets: market entry, market exit) suit the nature of a social market economy.

Integration can – and this is also a requirement of the social market economy – ensure that the factors of production are put to optimal use, increase prosperity and secure full employment. It helps social market economies to move forward if, in step with expanding technical advances, regional integration also brings about innovations.

The social market economy forces workers and businesses to abandon unprofitable jobs and places of production which are no longer competitive. But at the same time the social market economy is expected to assist such adjustment processes by enabling

employees and enterprises, through short-term, specialised training courses, to increase productivity and to offer their services successfully to the markets (→*structural policy*).

Such considerations are reflected in the rules for economic unions in the General Agreement on Tariffs and Trade (GATT). Article XXIV of GATT permits the formation of customs unions or free trade zones, provided that the tariffs are not higher in relation to third states than the tariffs for the member countries used to be before the establishment of the customs union or the free trade zone. Beyond that, it is necessary to specify a schedule which regulates the form and content of customs duty lowering procedures.

Since the adoption of the 1994 Marrakesh Agreement, relative to the exchange of services within free trade zones or customs unions, Article V of GATT requires that third states are not to be discriminated against, and/or that existing obstacles to the market access of enterprises in third states are to be eliminated.

Every customs union and every free trade zone has to be approved by the World Trade Organization (WTO). If unions violate the rights of third states, they have the possibility of having the discrimination removed through an arbitration procedure at the WTO and, if necessary, of forcing compensations for losses sustained. According to WTO data, between 1958 and 2003, 143 free trade agreements/customs union agreements in terms of Article 24 of the WTO were approved. In 37 of these agreements, the European Union (EU) is co-signatory. Twenty-seven service agreements were approved in terms of

Article V of GATT, and among them 14 under participation by the →EU.

Integration in its extent, form and organisation depends, among other things, on the performance level of the economy, on the availability of factors of production and on the readiness of the member states to cooperate. Areas of preference or associations are characterised by the fact that the members grant each other special tariffs. If the member states have agreed on exemption from customs duties, a free trade zone is formed. If common external tariffs are determined in relation to third states, it is referred to as a customs union. If factors of production enjoy freedom of movement between the states, a (common) domestic market has been created. If the member states agree on a common/harmonised economic policy, it is an economic community or an economic union. A common currency is the basis of a monetary union. If the member states also decide to share national organs and sets of rules in joint mechanisms and legislation, economic and political integration will be complete.

The EU example shows that integration on a free market basis can deepen the process of integration and attract more members. The quick collapse of regional cooperation in centrally managed economies – as in the case of the Council for Mutual Economic Cooperation (Comecon) – demonstrates the weakness of such economic systems and the risks inherent in non-free market integration. These integrations are of a purely political nature, since in a centrally managed economy the economy is centralistic and politically organised (→*socialism/planned economy*).

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*Karl Wolfgang Menck*

### Interest groups, lobbies

Interest groups are part of the phenomenon of today's democracies and are firmly embedded in the modern industrialised society. Interest groups used to meet the members of parliament in the vestibule of the British House of Commons, the so-called lobby, in order to discuss legal regulations and government interventions (lobbying). The 19th century saw the term 'lobbying' being incorporated into general linguistic usage in the United States and subsequently being used in Europe as well.

Interest groups or lobbies are defined as voluntary associations of persons and corporations established with the aim of bringing pressure to bear upon legitimate political representatives (in particular, the legislature and executive). The associations, also referred to as pressure groups, want to exert their influence on government decision-making processes, with particular emphasis on their own specific interests. Their involvement in the formation of the political will is not constitutionally regulated.

Interest groups take many different forms and can be roughly divided into

traditional profit-oriented groups and non-profit oriented groups, which are growing in number. They range from conventional trade unions and confederations for employers, industries, professions and farmers, to city alliances and taxpayers' associations all the way to groupings with philosophical, social or environmental orientations. In Brussels there are more than 6,000 different organisations representing interest groups. Lobbyism is becoming increasingly professional, i.e. public relations agencies as well as legal and consulting firms get themselves appointed as lobbyists and, with their know-how make themselves indispensable in the political decision-making and legislative processes.

#### *Why do these interest groups exist?*

'New political economics' sees the politician as an entrepreneur, out to collect the greatest possible number of votes which he/she wins by offering certain political outcomes, e.g. privileges such as transfer payments (social security contributions and government → *subsidies*, etc.) for certain groups of voters. In return, he/she expects political support (re-election). The more politicians can manipulate the (economic and) political status quo through their discretionary freedom to act, the easier it is for them to offer their constituents gifts, and the greater the difference interest groups can make.

Such lobbyists are typical of indirect democracies. Since the individual voter can rarely make an impact on political decisions on his/her own, collective representation is necessary. Lobbies enable their members to combine and articulate their concerns. They offer

possibilities for participation, communication and the allocation of values. The better they are organised and the more members they have, the stronger are the interest groups. However, too many members can weaken the impact and lower the chances of securing special privileges. Thus, lobbyists represent shared interests, while there are always those who are merely 'catching a ride'. This means that workers who are not affiliated with a trade union also receive pay rises without making any contributions.

#### ***How do interests groups work?***

Among other things, interest groups offer politicians financial assistance (donations), information, know-how, political advice, record keeping, posts on a supervisory board and well-paid jobs after the completion of their political careers. They can 'infiltrate' political parties with their members, and through the media they can support politicians or do them harm. Moreover, they can threaten to withdraw their support from a →*political party* or a politician at the next election, move enterprises to a different location, etc.

#### ***How should the existence of interest groups be evaluated?***

In large societies, a direct democracy is problematical. Through elections, representatives are selected, who have to take political decisions in keeping with the constitution. Interest groups have made it possible to organise the will of the electorate and to find out what they want. The existence of interest groups is an efficient way of conveying the needs of the population to the parliamentary representative.

But there are also disadvantages since the lobbyists can weaken the role of parliament in favour of the executive, and in communication with the ministerial bureaucracy, only their own special interests are promoted. This also means that minorities may be exploited if they cannot muster the required number of votes during the political process to represent their interests effectively. On the other hand, even majority groups of the population, which can be organised either with difficulty or not at all, can be exploited by powerful minorities. The effect that this has on economic policy is relevant because this is where financial redistribution is initiated. The state can apportion financial favours to certain subgroups of the population, but not without the remaining population having to pay for them.

Financially strong and well-organised interest groups have the ability to manipulate the state. This is referred to as the redistribution state, rent-seeking and haggling democracy. The high proportion of social security expenditure, the subsidy commitments and the associated diminished growth reflect the exaggerated influence of such interest groups in their attempt to evade the adjustments which →*competition* entails by lobbying.

Even the ordo-liberal Walter →*Eucken* expressed concern about the exaggerated influence of interest groups and included the principle of the delimitation of power of interest groups in his guidelines on government economic policy. Since lobbyists are perfectly able to enforce their wishes against the majority of the population and at their expense, the less powerful majority of a

society, the common good of a society, must be protected against the harmful influence of interest groups. While the state saw its purpose as imposing and keeping order, the influence of the interest groups was negligible. The transition to the 'welfare state' led to a 'politicisation of the economy' and to an 'economisation of politics'.

'The liberal, democratic state, which had been established in order to abolish the law of force through the force of the law, finds itself increasingly forced to abandon the force of the law to serve the law of force' (Kirsch, p.108).

### ***How can society protect itself against the harmful influence of the lobbyists?***

On the one hand, lobbyists are expected to adhere to transparency in their actions, as for example it is required in the United States where interest groups have to be registered. The 'public list of registered federations and their representatives' (lobby list) of the German *Bundestag*, on the other hand, includes only those federations that make an application in order to gain official access to parliament, the government and its sessions.

Since the large room for manoeuvre in politics is the cause for successful lobbying, this very room for manoeuvre would have to be limited. This would be possible by giving laws which accord certain sub-groups of the population preferential treatment only a limited period of validity (sunset legislation).

For example, if an interest group wins a subsidy it should be granted for a limited time only. After that, they must try again to enforce their special interests during the political process. It

must then be hoped that groups which are disadvantaged by the current legislation are equally keen lobbyists.

A mandatory analysis of the distribution effects of all legislation projects that do not meet the principle of universality would be helpful. This would increase transparency and would alert competing interest groups to the threat of financial disadvantages. The exaggerated influence of interest groups in contemporary society can lead to the state degenerating into a redistribution agency and increasingly losing its function as an organising force.

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### **International currency system**

The international currency system includes all agreements and institutions that exist to ensure the smooth execution of international monetary transactions (→*currency system and exchange rate regimes*).

The organisation of this system has a significant impact on the international division of labour, the level of income and the employment levels of the countries concerned.

On the one hand, the subject of international agreements is a structural framework for free currency exchange (convertibility of currencies). This refers primarily to the kind of exchange rate system and currency reserves. Basically, there are three different exchange rate systems.

In the system of 'flexible exchange rates', the exchange rates (exchange ratio of two currencies) form freely through → *supply and demand* in the foreign exchange market. Government interference (generally by the national central banks) in order to modify this exchange ratio does not take place.

In systems of 'fixed exchange rates', the exchange ratios between the currencies of several countries are fixed by contractual 'parities'. Deviations from the agreed exchange rate (or a certain range that has been agreed and within which the rate of exchange can move freely up and down) force the national central banks to intervene in the foreign exchange market, in order to keep the exchange rate within the permissible range.

'Currency board systems' represent the hardest form of exchange rate adjustment ('hard peg'). The creation of a national currency exclusively through the purchase of a reserve currency with a fixed link to the exchange rate of this anchor currency, provides complete coverage of the circulating money supply through the anchor currency reserve of the currency board. Variations of this system are referred to as steered exchange rate systems, which are located in the spectrum somewhere between flexible and firm exchange rate systems. Among these are 'controlled floating' (basically flexible exchange

rates with foreign exchange market interventions by the central banks if required), 'crawling pegs' (parities which are adjustable gradually, e.g. monthly) or 'graduated flexibility' (generally fixed exchange rates with occasional changes of parity, e.g. the Bretton Woods system, the European Monetary System).

Especially in the case of fixed rate systems, the central banks have to hold currency reserves in their portfolio in order to be able to fulfil their intervention obligation, if necessary, in the form of currency purchases or sales in the foreign exchange market. Currency reserves include the gold reserves of the central banks, their foreign exchange reserves as well as their reserves of artificially created currencies (e.g. special drawing rights of the International Monetary Fund). This is conditional upon international agreements, which guarantee the convertibility of the reserve medium (commutability of the reserve medium into other currencies under market conditions).

Other international agreements concern the creation of a systematic framework for the free international payment and capital flow. Certain countries could potentially be opposed to the systems-theoretical justification of the advantages of free capital transactions (capital mobility) on the grounds of their political and economic interests.

Balance of payment problems or exchange rate targets are frequently the causes for capital movement controls on the part of the countries concerned. Capital transaction controls can take the form of quantitative restrictions or taxes on international financial transactions.

These include the duty to obtain permits to raise loans abroad, the restriction of cross-border portfolio investments, or interest equalisation tax payments on yields from foreign investments.

Based on the unfavourable effects of capital movement controls on economic →*integration*, →*growth* and prosperity, international agreements (e.g. IMF statutes, EEC Treaty) are aimed at the dismantling of capital movement controls. The supervision and implementation of monetary agreements are incumbent upon national and supranational organisations. The responsibility for monetary policy matters at national level is mostly reserved for the respective central banks. They are obliged to ensure currency stability (→*price level stability*) as well as the proper execution of capital transactions. In addition, an intervention obligation exists for fixed exchange rate systems.

As a supranational organisation, the Bank for International Settlements has the task of promoting cooperation among the central banks, identifying new opportunities for international financial transactions and playing the role of trustee or agent in respect of the capital transactions with which it is entrusted.

The contribution to the promotion of world trade and prosperity by the member states of the IMF consists in the commitment of these states to close cooperation in international monetary policy matters and capital movement, as well as to mutual financial assistance in the event of balance of payments problems.

The institutions of the World Bank Group are pursuing the common goal of supporting economic development

in less-developed member states through financial assistance and advice (→*international organisations*).

Problems for international currency regulations result from the increasing →*globalisation* of the financial and goods markets as well as from →*enterprises*. Volumes and the (increasingly speculative) volatility of capital flows and the monetary crises which result (e.g. the Asian crisis in 1997) require the reform of the existing global currency regulations. Suggestions in this regard are especially focused on greater transparency (early warning signs of financial crises, safety standards in the context of government supervision of the banks) and on the areas of competence of supranational monetary institutions (e.g. the IMF).

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Carsten Eppendorfer

## International Labour Organization

The International Labour Organization (ILO) was created in 1919 as a three-tiered organisation. Representatives of employees and employers cooperate equally with governments. They are working towards the development of



joint interventions for the promotion of social justice and improved living conditions all over the world.

This goal is based on the statement in the preamble of the ILO constitution that world peace, if it is to last, can only be built on →*social justice*. This still continues to be true today and serves as the basic orientation for all ILO activities. The Declaration of Philadelphia (adopted in 1944 as an appendix to the constitution of the ILO) clarifies this basic orientation further. It declares the right of all people to strive for material prosperity, spiritual expression, freedom, dignity and financial security under equally favourable conditions. Furthermore, the declaration reads: 'Poverty, wherever it exists, endangers the prosperity of all.'

In 1946, the ILO became the first special organisation of the United Nations. In 1969, it received the Nobel Peace Prize. The ILO had 177 member states in 2004. Its main body, the International Labour Agency (ILA), has its headquarters in Geneva.

Its highest executive organ is the International Labour Conference (ILC), which meets for several weeks every year. The board of directors, together with the ILA, essentially works in preparation for this conference.

The ILO also works through further committees, such as regional meetings, industrial advisory bodies and groups of experts. The ILA is headed by a general manager who has been selected by the board of directors.

From the outset, the main task of the ILO was to improve employment and living conditions through agreements and recommendations. This task of setting standards continues to be the focus

of the activities of the ILO. The ILC had up to 2004 adopted a total of 378 international work certificates (184 agreements and 194 recommendations). Furthermore, the ratifications of approximately 6,000 agreements have been registered with it. The agreements deal with a wide range of social problems, including key fundamental rights (such as freedom of association, the eradication of hard labour and the removal of discrimination in the workplace), minimum wages, labour administration, worker relations, →*employment policy*, working conditions, social security and →*occupational health and safety*.

The agreements and recommendations form the International Labour Code. The significance of the standards which it contains goes far beyond the regulated issues alone. These standards represent the practical application of many principles which form part of the General Declaration of Human Rights and the International Human Rights Pacts of the United Nations. Furthermore, they represent a wealth of experience which is at the disposal of countries at all levels of development.

The International Labour Code has a considerable impact on the development of welfare legislation worldwide. Through the ratification of an agreement, member states enter into a two-fold obligation: on the one hand, the regulations contained in the agreement become binding; on the other hand, the states are subjected to a certain degree of international 'control'. However, this has not so much the character of judicial decisions than that of a constant dialogue through which political pressure is exerted if compliance with the regulations is unsatisfactory.

Since 1964, thanks to the reports submitted by the controlling bodies of the ILO, it has been possible to harmonise national laws and practices with the regulations of ratified agreements in approximately 2,000 cases. Furthermore, the organisation has stepped up its activities for the support of member states in this area, particularly through the increasingly frequent establishment of direct contacts with governments, through their regional advisers for international employment standards, by organising seminars and training courses, and through the dissemination of information on the standards and principles of the ILO. Today, the programmes of technical cooperation concentrate on the following key areas:

- *Employment and development*: Definition of national policy and strategies; staff planning; special labour-intensive programmes for public work; poverty reduction in rural areas; technological equipment and development of small businesses.
- *Training*: Support with the detailed development of training policies and systems; training of top management staff and business development; vocational training in industry, rural areas and commerce as well as the development of training methodologies and material. Specific attention is paid to vocational training for the handicapped and training for women and youth who have never been to school.
- *Activities classified in terms of industries*: Particularly in favour of the development of cooperatives and programmes for the shipping industry.
- *Employment conditions and the working environment*: →Occupational health and safety, employment and living conditions.
- *Employment relations (including employment administration)*: Social security, worker education and support for employers' associations.
- *Child labour*: The ILO has made it a priority to assist many countries with the eradication of child labour. The research activities of the ILA are intended to lead to new insights into labour problems and to suggest possible solutions. Such research activities are often incorporated into the compilation of reports for the International Labour Conference and other meetings.
- *Setting standards, technical cooperation, and research*: These three tasks of the ILO support each other while being interdependent. In active partnership with governments, employers and employees, the aim is to create social justice for the whole world.

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Peter Clever

## International migrations

### Facts

The history of mankind is also a history of migrations. Since there has been *homo sapiens*, there has also been *homo migrans*. The story of the expulsion from paradise at the beginning of the Bible is well known, and the New Testament starts with the story of an escape.

World history is full of many other examples documenting the history of migration, whether it relates to conquest, destruction, suppression, expulsion or exclusion. After birth and death, migrations are the third determining factor for the way a population develops (→*demographic development*).

### *The forgotten historical dimension...*

The history of mankind has always known strong migratory movements. One need only be reminded of the population migrations of antiquity and the Middle Ages, or of the waves of inter-continental emigration from Europe to the New World and the distant colonies. The migratory flows of the 19th century consisted mainly of an ongoing emigration from relatively rich European countries to relatively poor traditional host countries such as the United States (US), Canada, Australia, New Zealand and Latin America. At that time, the main focus of interest was on the consequences of emigration.

After the Second World War, the migratory flow started to change direction. Initially, the migration of labourers from poorer countries in the South to the richer industrial nations of the North became prominent and manifested itself in the immigrant worker

programmes in Europe and the Bracero programme between Mexico and the US, which had originally been conceived on a strictly temporary basis. However, it soon became obvious that there was nothing more permanent than the supposedly temporary migration. Sooner or later the immigrant workers brought their families with them; these formed social contacts and groups that wanted to be heard in the political arena.

Apart from the economic consequences, immigration also caused a number of urgent social and political problems (regarding distribution). The latter became increasingly obvious as more asylum-seekers and refugees (from political violence) began to influence the European migration statistics.

### *...and the overrated dimension of the present day*

Across the globe, an estimated 150 million people are not living in their countries of origin. This roughly equals the population of Russia, which is in sixth place on the list of the world's most populous countries. However, relative to the world's population of six billion, the proportion of foreigners shrinks to as little as 2-3%! In other words, 97% of people live in the country whose nationality they possess. It is true that many 'inhabitants' were born as 'foreigners' who have changed nationality in the course of their lives and thus dropped out of the immigrant statistics, so that the migration figures are probably higher than the estimated 150 million.

Even within culturally and linguistically very similar 'natural' living spaces, the transnational, international migra-

tion remains low – even within the European Union (→EU).

Although within the EU freedom of movement applies to all workers and their families, there have hardly been any strong migration movements. Only in Belgium does the proportion of EU foreigners reach 5% of the resident population. In France, Germany, Sweden and Ireland, only about 2% of the resident population are EU foreigners, while in all other EU countries the proportion of EU foreigners of the resident population is about 1%.

All in all, even in the age of →*globalisation*, *homo migrans* still remains part of an infinitesimal minority. From a euro-centric point of view, it must not be forgotten that the South–South migrations in Africa or Asia are still quantitatively more significant than the South–North or East–West migrations. They became more dramatic because during the 20th century, national borders which had been artificially determined by (European) colonisers and their descendants resulted in strong migratory movements, often within the same cultural group, in Africa, Asia and Latin America. World wars and political decisions taken at the drawing board did the rest, so that during the 20th century people not only had to flee, but also that in Europe, just like in Africa and Asia, probably far more borders were shifted across people than people moved across borders.

### **Causes**

Migratory phenomena can have a combination of different causes. Generally, economic factors are a necessary, but definitely not a sufficient, motive for migration.

### *Microeconomic factors*

From an economic perspective, the decision to migrate is the result of an individual search and optimisation process. It is assumed that people weigh up rationally the pros and cons of moving or staying, and that through their actions they aim at maximising their personal benefit (quality of life). It follows that people are prepared to move if migration, by comparison with staying, suggests a greater personal benefit.

From the perspective of the individual, the decision to migrate is the properly considered result of an evaluation process. The personal situation (age, sex, health, family status, number of children, investments in one's own human capital) determines the migration behaviour of the individual. It is not difficult to understand why younger, single men in good health generally exhibit greater mobility than older, married men with children. But instead of regarding migration as the well-considered consequence of an individual decision, the emigration of an individual can be interpreted as strategic behaviour by a family or a micro population group.

By way of a distribution of risks, the family or group decides to send some of their members 'on migration' (comparable to the risk distribution strategy within the portfolios of a capital investor). Successful immigrants encourage other family or group members to follow, and they facilitate access to the target country for these (the snowball effect, which can lead to network migration). Less successful migrants either move back or try their luck in other target countries. For the family or the group, this collective behaviour

leads to a risk reduction (one will make it), and in the longer term also a reduction of costs ('bad' target countries can be replaced by 'promising ones').

#### *Macroeconomic factors*

From a macroeconomic perspective, the different living conditions of different regions in the world are an important factor for triggering migration processes, which can take place for economic reasons (different per capita income) or political reasons (war, instability, a lack of legal security, insufficient protection for minorities or a lack of basic human rights, among many others).

But emigration can also be a reaction to the lack of local initiatives aimed at structural transformation from an agrarian to an industrial society. Finally, ecological collapse also tends to create environmental refugees.

#### *Consequences*

The effects of migration are complex and manifold. Above all, the time factor and the reciprocal effects are important. Short-term effects regarding different standards are superseded in the long term by growth effects. Immigration modifies the available labour supply and thus the relative scarcity of the factors of production.

#### *Macroeconomic consequences of immigration*

Labour migrations are positive in many respects. They have a balancing effect. Immigration satisfies demand in the job market and allows the recruitment of heads or hands which are needed at home from outside the country. Migration is therefore a kind of arbitrage phenomenon. It helps to balance

price (= wage) differences in the job markets.

Thus from the economic perspective, the yardstick is the 'law of the uniform price' as a benchmark for efficiency. This rule means that (tradable) goods must cost more or less the same all over the world and that the net purchasing power of hourly wages for identical work ought to be similar worldwide. Therefore, macroeconomically, immigration is positive for the host country because it contributes to stability or even to a lowering of wage levels, while at the same time →*employment* and demand are increased. Like free trade on goods markets, the free migration of the factors of production is an indispensable condition for the →*growth* of the national product.

Migration can, however, also be judged more critically. If not only the extra hands but also the clever heads move, the consequences can be completely different. This phenomenon is called 'brain drain' and could, for example, be observed in the case of the South–North migration in Italy. In that case, migration is not just a compensatory regulation or a short-term arbitrage phenomenon, but a self-perpetuating cause for the accelerating pace of the divergent economic development of factor-exporting poor and factor-importing rich countries. It increases the prosperity gap between underdeveloped (peripheral) and industrialised target regions.

#### *The distribution problem*

The problem of migration lies in the fact that although immigration is on the whole positive for the national economy, not all local people benefit from it.

Immigration triggers a structural transformation which in the long run is urgently needed and which boosts average productivity. In the short term, however, it can cause displacement effects for individual people. This is particularly detrimental for those locals who occupy jobs in the production process, from which they are displaced by the immigrants.

If, for example, as in the case of the information technology (IT) 'green card', data-processors required in the German job market are recruited abroad, the wages of local professionals in more or less the same positions will tend to fall. Complementary German factors of production (e.g. employing companies), however, benefit. Owing to the immigrant IT specialists, their own productivity rises.

Lastly, immigrants compete with local people for the following:

- Social security benefits, either funded directly through contributions or indirectly through tax payments.
- The use of public goods (the legal system, the judiciary, internal and external security), infrastructural installations (transport, telecommunications and energy networks) and services (the health and education systems), which are available to all and which are financed directly through levies and fees or indirectly through taxes.

How much immigrants contribute to the funding of the social and welfare benefits which they claim and the public goods which they utilise is closely linked to the opportunities that are

open to them in the job market, both in terms of market conditions and from the point of view of immigration law. The duration of their stay and the process of integration or assimilation are equally important.

To be able to judge the effects of immigration one has to take into account agglomeration or concentration, as well as displacement effects. In this case, one is less concerned with the objective macroeconomic burden than with subjective individual hardships.

In Europe, labour will be in increasingly short supply in the future. The falling birth rate during the past 10 years will cause a recruitment problem in years to come – particularly also within those areas of the →welfare state where future generations have to solve inherited burdens.

As Western Europe is ageing demographically – because there are more and more older people and fewer and fewer young people – it will become increasingly urgent to be able to access foreign labour markets (→demographic development). It also has to be remembered that in a highly globalised world with a highly differentiated division of labour, isolated national job markets increasingly have to be seen as an anachronism (→globalisation): it is expensive, requires expensive control mechanisms and provokes illegal (evasion) deals. The European migration problem of the 21st century thus is not caused by too much mobility but by too little.

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Thomas Straubhaar

## International organisations

The debate about the organisation of political cooperation and monetary systems, as well as the international exchange of goods and services, goes back to long before the Second World War. Up until the beginning of the First World War, the world economy was largely self-regulating without contracts based on international law and international institutions, through free trade and a stable monetary system (the so-called gold standard).

As the dominant political and economic power of this time, the United Kingdom (UK) represented the relevant organising factor (*Pax Britannica*). This state of affairs was frequently used as a point of reference in subsequent efforts to repair the international structures which had been destroyed by the First World War.

After the First World War, it was hoped that the League of Nations as a system of states would restore political stability that had failed due to the lack of a strong political and economic organising power such as the UK had been before the First World War. Also the United States (US) was not yet ready for this task.

Within the international trade zone, too, a reliable system with which to curb protectionism could not be achieved. The First World War had irreversibly damaged the structure of the

global economy. The world economic crisis that started to make itself felt in 1929 led to the final break-down of the unstable international currency and commercial systems.

This sequence of events was typical of the governments of that era and their refusal to make allowances for the international economic and political consequences of strictly self-interested, non-cooperative and aggressive economic policies. The effects on the economy were catastrophic, and included the collapse of the currency and the stock exchange, shrinking productivity, a 50% reduction of world trade, falling prices and wages, and rising unemployment. The economic crisis had grave political consequences such as the rise of national socialism in Germany.

This political and economic crisis has always served as a warning and as a reference point for the post-Second World War economic system. Thus even before the end of the Second World War a vision of a new international community emerged, which no longer only relied on political cooperation. The integration of all major nations with regard to currency, trade and development corresponded to the goal of globally reducing the likelihood of future conflicts turning into war and was therefore supposed to form the basis for a new system, the so-called peace order.

The establishment of new international organisations was discussed. The conference of Bretton Woods (US) in 1944 sealed a new monetary union of 44 states in a fixed rate system (→*currency system and exchange rate regimes*) with the dollar as the key currency and thus indi-

### Brief summary of some international organisations

#### ***International Monetary Fund (IMF)***

- Established 1944 in Bretton Woods (US); Headquarters: Washington, D.C. (US); Members: 182.
- Aim: Promotion of international cooperation in the field of monetary policy, especially the stabilisation of the exchange rate.
- Instruments: Monitoring and assessment of members' exchange rate policy; financial aid (credits and loans) to create balance of payments equilibrium, mostly associated with economic policy conditions; skills transfer in the areas of monetary and fiscal policy.
- Internet: [www.imf.org](http://www.imf.org)

#### ***World Bank (formerly: International Bank for Reconstruction and Development)***

- Established 1944 in Bretton Woods (US); Headquarters: Washington, D.C. (US); Members: 184.
- Aim: Development aid for poverty reduction and for the creation of sustainable growth in the world's poor and poorest countries; support particularly in the areas of education and health.
- Instruments: Financial support (loans and credits); analysis and consultancy; skills transfer.
- Internet: [www.worldbank.org](http://www.worldbank.org)

#### ***United Nations Organisation (UNO)***

- Active since 1945; headquarters: New York; Members: 191.
- Aim: Protection of peace and security, preservation of human rights, peaceful cooperation between the nations, arbitration in international military, economic, social, humanitarian and cultural conflicts.
- Instruments: The 'family' of the United Nations includes 15 sub-organisations as well as diverse programmes and committees with their own agendas and budgets.
- Internet: [www.un.org](http://www.un.org)

#### ***General Agreement on Tariffs and Trade (GATT) and/or World Trade Organization (WTO)***

- Multilateral treaty, agreed 1948 in Geneva (Switzerland); Headquarters: Geneva; Members: 142 (WTO).
- Aim: Removal of obstacles to trade and tariffs, signed as the basis of a trade organisation which was subsequently not established; gradually took on the character of an international organisation.
- Instruments: Official negotiations with all partners to the agreement; application of the principle of the most-favoured nation clause (if one member country is granted preferential tariffs, it immediately and unconditionally applies to all the other members) and reciprocity (equal concessions for rebates) among the partners to the agreement as well as the prohibition to tighten existing and to introduce new obstacles to trade; opportunities to settle conflicts, supervision and analysis of the member countries' trade policies, special status for developing countries (so-called Enabling Clause).
- Result: The negotiations led to a reduction of customs duties worldwide and to the prohibition of any kind of quantity-based obstacles to trade; the last round of negotiations (Uruguay 1986-1994) resulted in the establishment of the World Trade Organization (WTO), the successor organisation, on 1 January 1995.
- →World trade order
- Internet: [www.wto.org](http://www.wto.org)



rectly the US as the controlling power. The International Monetary Fund (IMF) was established for the monitoring and stabilisation of the system, and the World Bank was established for the promotion of global economic development. The establishment of the United Nations Organisation (UNO) in 1945 formed the basis for worldwide political cooperation; later, its individual subsidiary organisations came into being. The expansion of international trade was built on the General Agreement on Tariffs and Trade (GATT), which was replaced by the World Trade Organization in 1995.

In the meantime, other international organisations have been created and today represent important participants on the political landscape. An international organisation is generally defined as an association of several members across national borders; multinational corporations are excluded here. It is estimated that in 1995 there were

approximately 3,000 to 4,000 such organisations. They are specifically expected to coordinate cooperation in different areas, usually aided by a framework of laws and regulations on a contract basis, as well as the creation of a communication platform to facilitate ongoing dialogue between the members.

But more distinctions can be made using various characteristics. The working group represents a significant distinguishing feature for international organisations. Thus governmental agencies (e.g. the World Trade Organization) should be distinguished from non-governmental agencies (e.g. Amnesty International). The proportion of governmental organisations to non-governmental organisations is approximately 1 in 10. The governmental international organisations are of special interest.

Whether or not a country is a member of an international organisation can

<b>GATT negotiations on the reduction of customs tariffs</b>						
<b>Place/ Name</b>	<b>Start</b>	<b>Duration</b>	<b>No. of countries participated</b>	<b>Weighted reduction of customs tariffs (%)</b>	<b>Trade affected by reduced customs tariffs in: US\$ billion    % of trade worldwide</b>	
Geneva	1.4.1947	7 months	23	19	10	~20.0
Anncy	1.4.1949	5 months	13	2		
Torquay	1.9.1950	8 months	38	3		
Geneva II	January 1956	5 months	26	2	2,5	2.7
Dillon	1.9.1960	11 months	26	7	4,9	3.5
Kennedy	May 1964	37 months	62	35	400	18.6
Tokyo	1.9.1973	74 months	102	34	148	9.0
Uruguay	1.9.1986	87 months	123	38	464	25.0
<i>Created WTO to replace the GATT</i>						
Doha	1.11.2001	to be continued	141			

have an immense impact on its sovereignty and thus on the national economic policy. The range of an international organisation over time in terms of its issues, geographically and legally, as well as its degree of competence is also important for the members. In terms of economic policy, international organisations play the most important role in the sphere of the economy, most of all in regulating capital flows, payment transactions and also trade.

Geographically, the most diverse constellations are possible – from regional associations (e.g. the →EU) to continental or multi-regional ones (e.g. the North American Free Trade Association – NAFTA), all the way to global organisations that cover whole continents (e.g. →*International Labour Organization*).

The legal range has many facets. The contractual commitment to committee resolutions of the organisation, the voting and delegation rights in the committees, the membership conditions in the organisation, the following of guidelines and innumerable other aspects are agreed and implemented in each international organisation in a different way. The specific legal arrangements, however, determine the degree of competence of the organisation and thus the influence on the national policy (and therefore the economic policy) of the member states. They also determine whether the organisation can reach its objective and whether it can continue its process of integration.

Over time, the formal (contractually fixed) organisations were complemented by informal ones, and it is the latter which can also have a significant influence on world politics and events

in the individual states (e.g. the World Economic Summit). In this way, international organisations make a substantial contribution to →*globalisation*.

In principle, the international organisations in the economic sector caused the world economy to stabilise and created, simultaneously with the political rapprochement, the basic conditions for a more even development of mankind in the future. The process of international rapprochement was, and still is, always accompanied by setbacks, but the new system has showed itself to be relatively resilient and stable. Without doubt, today's international order can be described as the historically unique result of efforts to achieve a free and democratic world.

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Marina Ignatjuk

## Interventionism

Planned economies of socialist administrations (→*socialism/planned economy*) are characterised by systematic and comprehensive state interventionism for the fulfilment of the government's economic targets. In contrast to this, interventionism (→*interest groups, lobbies*) in →*market economies* serves to

modify informally specific aspects of the structure, execution and results of market processes (specifically targeted).

In particular, associations, →*political parties* and national bureaucracies promote interventionism in the political process of a democracy. →*Enterprises*, industries, regions and voter groups ask for financial privileges and index-linked pensions, which cannot be granted in the desired way within the limitations of a competitive economic system. The parties hope it will bring them votes, while associations hope it will bring them members.

Through political and economic interventions, the national bureaucracies benefit by expanding their responsibilities and powers, and by administering the requisite budgets which they can use to secure their own incomes and financial gain. It is often easier to win approval for specifically targeted interventions in the political process due to the fact that the benefits are equally specific, while the costs can be spread out thinly, are hardly noticeable, and thus not really attributable.

A large variety of only inaccurately defined goals are pursued with interventions. The vague delineation gives the activists more scope to take decisions. This, in the end, is used to obtain economic or social outcomes that are supposed to be unattainable through the process of free market →*competition*: for example, the preservation and creation of jobs in certain enterprises, industries and regions, and the organisation of economic structures regarding certain developmental, industrial, social or integrational policy goals.

Particularly during periods of economic downturn and at times of struc-

tural transformation, increasingly interventionist trends have to be expected. Strong tendencies are emerging in the transition societies of Central and Eastern Europe to cling to the familiar systematic interventionism and the associated security of economic and social positions.

Although the interventions are specifically targeted, they affect other areas. This often makes it necessary to follow one intervention with others in order to correct the unwanted effects of the first one. In such intervention chains, each intervention involves further interventions. Thus interventionism spreads like an oil stain.

Any parameter of action which is relevant to a competitive system can be used as a point of departure for interventions: market entry and market exit conditions (→*open markets*); price charges and clearing; quantity regulations (quotas) in the area of the factor and product markets; production and quality regulations; company investment and marketing policy. The interventions can be limited to sectors or regions, but they can also refer to enterprise and product-specific restrictions of free market exchange.

Apart from distortions and falsifications of the national and international division of labour and competition, the consequences of interventionism include a lack of respect for a superordinate idea of political and economic action, roughly similar to the 'economic constitution of competition'.

Through their cooperation with interest groups and political party groupings, the state intervention departments assume the character of independent economic and socio-polit-

### Transparency International Corruption Perceptions Index 2007

Rank	Country/ Territory	CPI Score	Rank	Country/ Territory	CPI score	Rank	Country/ Territory	CPI score
1	New Zealand	9.4	61	Cuba	4.2		Ukraine	2.7
	Denmark	9.4		Poland	4.2		Benin	2.7
	Finland	9.4		Tunisia	4.2	123	Guyana	2.6
4	Singapore	9.3	64	Bulgaria	4.1		Zambia	2.6
	Sweden	9.3		Croatia	4.1		Comoros	2.6
6	Iceland	9.2		Turkey	4.1		Nicaragua	2.6
7	Netherlands	9.0	67	El Salvador	4.0		Viet Nam	2.6
	Switzerland	9.0	68	Colombia	3.8		Mauritania	2.6
9	Norway	8.7	69	Ghana	3.7		Niger	2.6
	Canada	8.7		Romania	3.7		Timor-Leste	2.6
11	Australia	8.6	71	Senegal	3.6	131	Nepal	2.5
12	Luxembourg	8.4	72	Morocco	3.5		Yemen	2.5
	United Kingdom	8.4		China	3.5		Philippines	2.5
14	Hong Kong	8.3		Suriname	3.5		Burundi	2.5
15	Austria	8.1		India	3.5		Libya	2.5
16	Germany	7.8		Mexico	3.5		Iran	2.5
17	Japan	7.5		Peru	3.5		Honduras	2.5
	Ireland	7.5		Brazil	3.5	138	Pakistan	2.4
19	France	7.3	79	Serbia	3.4		Ethiopia	2.4
20	United States	7.2		Georgia	3.4		Paraguay	2.4
21	Belgium	7.1		Grenada	3.4		Cameroon	2.4
22	Chile	7.0		Trinidad and Tobago	3.4		Syria	2.4
23	Barbados	6.9		Saudi Arabia	3.4	143	Gambia	2.3
24	Saint Lucia	6.8	84	Bosnia and Herzegovina	3.3		Indonesia	2.3
25	Uruguay	6.7		Montenegro	3.3		Togo	2.3
	Spain	6.7		Maldives	3.3		Russia	2.3
27	Slovenia	6.6		Jamaica	3.3	147	Angola	2.2
28	Estonia	6.5		Kiribati	3.3		Nigeria	2.2
	Portugal	6.5		Gabon	3.3		Guinea-Bissau	2.2
30	Israel	6.1		Swaziland	3.3	150	Sierra Leone	2.1
	Saint Vincent and the Grenadines	6.1		Thailand	3.3		Kazakhstan	2.1
32	Qatar	6.0		Lesotho	3.3		Belarus	2.1
33	Malta	5.8		FYR Macedonia	3.3		Zimbabwe	2.1
34	Macao	5.7	94	Madagascar	3.2		Côte d'Ivoire	2.1
	Taiwan	5.7		Sri Lanka	3.2		Tajikistan	2.1
	United Arab Emirates	5.7		Panama	3.2		Liberia	2.1
37	Dominica	5.6		Tanzania	3.2		Congo, Republic	2.1
38	Botswana	5.4	98	Vanuatu	3.1		Ecuador	2.1
39	Hungary	5.3	99	Dominican Republic	3.0		Azerbaijan	2.1
	Cyprus	5.3		Armenia	3.0		Kenya	2.1
41	Czech Republic	5.2		Lebanon	3.0		Kyrgyzstan	2.1
	Italy	5.2		Mongolia	3.0	162	Bangladesh	2.0
43	Malaysia	5.1		Algeria	3.0		Papua New Guinea	2.0
	South Korea	5.1		Belize	3.0		Turkmenistan	2.0
	South Africa	5.1	105	Argentina	2.9		Central African Republic	2.0
46	Costa Rica	5.0		Djibouti	2.9		Cambodia	2.0
	Bhutan	5.0		Albania	2.9		Venezuela	2.0
	Bahrain	5.0		Burkina Faso	2.9	168	Laos	1.9
49	Slovakia	4.9		Bolivia	2.9		Equatorial Guinea	1.9
	Cape Verde	4.9		Egypt	2.9		Guinea	1.9
51	Latvia	4.8	111	Moldova	2.8		DRC	1.9
	Lithuania	4.8		Eritrea	2.8	172	Afghanistan	1.8
53	Oman	4.7		Guatemala	2.8		Sudan	1.8
	Jordan	4.7		Rwanda	2.8		Chad	1.8
	Mauritius	4.7		Solomon Islands	2.8	175	Uzbekistan	1.7
56	Greece	4.6		Mozambique	2.8		Tonga	1.7
57	Namibia	4.5		Uganda	2.8	177	Haiti	1.6
	Seychelles	4.5	118	Mali	2.7	178	Iraq	1.5
	Samoa	4.5		Malawi	2.7	179	Somalia	1.4
60	Kuwait	4.3		Sao Tome and Principe	2.7		Myanmar	1.4

A country or territory's CPI Score indicates the degree of public sector corruption as perceived by business people and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt)

Source: *Transparency International Secretariat*

ical authorities. The state loses the ability to act appropriately and becomes subjected to persistent blackmail attempts on the part of the groupings which have already been accorded special privileges. Interventionism is susceptible to corruption, a mentality of entitlement and criminality.

In order to avoid this, specifically targeted interference with the economic process should be limited to cases that are – as with certain kinds of environmental damage (→*environmental policy*, →*environmental protection objectives*) or disasters – associated with negative external effects, which can either not be eliminated at all, or not be eliminated sufficiently or fast enough through inclusion (internalisation) into the free market system.

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## Keynesianism

Keynesianism is based on the theories of John Maynard Keynes (1883–1946) and develops these in the context of post-Keynesianism or new Keynesian macroeconomics. Keynes's major work *The General Theory of Employment, Interest and Money* (1936) must be seen in the

light of the world economic crisis. The long, ongoing period of involuntary →*unemployment* generated doubt regarding the classical theory, whereby the self-regulating and self-healing powers of the market are relied on and controlled by prices (→*liberalism*). Keynes developed a demand-based model able to explain the under-used factor labour and offering economic policy measures designed to reverse unemployment.

Insufficient macroeconomic demand means that the →*enterprise* cannot sell the desired quantities in the goods markets. Due to assumed price rigidities (lacking downward mobility of prices and wages), the suppliers' reaction to these marketing difficulties would be a reduction of the product quantity, which in turn entails a decreased demand for workers. The shrinking demand for services means a reduction of the scarcity of the factor of production labour, and therefore leads to shrinking wages or available →*income* in private households. Macroeconomically, the national income goes down.

In the Keynesian system of explaining economic relationships, consumption depends on the available income alone, which causes a spiral of cumulative downward movements (Keynesian income dependence of consumption) to develop. A reduced national income leads to a weaker purchasing power of the private households, making private consumption shrink. Since consumption is a component of total demand, it equally goes down. The economic agents now require fewer goods than the enterprises would like to sell. For a shrinking production, the suppliers

need smaller quantities of the factor of production work and therefore continue to reduce their demand in the labour market. The price of work, i.e. the rate of pay, continues to go down in this way. The consequence of this is a further reduction of available income, which starts off the second round of the downward spiral. This process ends only when a general, temporary equilibrium is reached with reduced demand and unemployment.

A second, significant component of the Keynesian theory is based on the assumption that private economic activities and thus the  $\rightarrow$ market economy has an inherent tendency to be unstable or imbalanced. An uncertain future affects the demand for capital goods and the attitude to capital investments, which fluctuate as a result. Waves of optimism and pessimism disturb an even, balanced process.

During periods of depression, the monetary policy of the central banks can lose its motivating effect on the economic activity in real terms. The economic agents then start to hoard all the additional liquidity which has been pumped into the national economy through interest rate reductions and increased money supply, instead of using it for purchases of investment or consumer goods (liquidity trap). This leads to disturbances in the circular flow of income and triggers recurring situations of imbalance.

The significance of demand, the tendency of a free market to become unstable, and the ineffectiveness of monetary policy measures during an economic downturn or low point, are the reasons why Keynes puts great emphasis on an anti-cyclical fiscal poli-

cy, i.e. stabilisation of the economic situation through government interventions ( $\rightarrow$ business cycle policy).

In phases of economic downturn (recession), government has to boost income and purchasing power of consumers through tax reductions, while generating consumer demand through an expansive fiscal policy and loans (additional public investments, deficit spending), which revives overall economic activity and from which workers and businesses benefit in equal measure. During a boom, on the other hand, government has the task of slowing down demand through a restrictive fiscal policy (revenue from tax increases which is not spent, cutting back expenditure, creation of a budget surplus) and to put the brakes on a run-away economy.

In this theory, Keynesianism uses the plausible concept that in a market economy where workers and businesses are not working to capacity, a demand increase also increases the productive output and  $\rightarrow$ employment. The experiences of the war and post-war period confirm the view that in a market economy, in order to bring back full employment the state is entitled – and in exceptional cases even obliged – to soften recurring phases of intensified unemployment through its spending on consumer and capital goods purchases. This school of thought forms the basis of the Stability and Growth Act which came into force in 1967, but which by the late 1970s had already lost its impact on account of the fact that both the underlying concept and the economic policy instruments had become obsolete.

The politics of demand of Keynesianism were replaced by politics of

supply, which consider monetary and anti-inflationary policies as well as non-governmental activities as potentially more effective.

There are many fundamental differences of opinion between the two views and therefore the main economic policy instruments also differ. Keynesianism relies on state-implemented fiscal policy, and →*monetarism* favours political control of the money supply through the central bank as well as market-inherent incentives. Depending on the view they support, representatives of the different strategic policies for stabilising business cycles are referred to as Keynesians, fiscalists or monetarists.

The academic debate around the further development of Keynesian teachings concentrates on an improved microeconomic foundation for the assumptions and effect relationships, as well as on the underlying reasons for wage and price rigidities by contractual commitments.

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## Labour law

Labour law regulates the relationship between employees and employers. A difference has to be made between individual labour law (the legal relationship between the individual employee and his/her employer), collective labour law (the legal relationship based on shop floor agreements, collective agreements or corresponding agreements for the public service) and →*occupational health and safety* regulations for the protection for the employees.

One part of labour law is based on national regulations (laws and regulations), while the other part consists of autonomous regulations by the involved parties that are legally binding for those concerned (single contracts, plant agreements, collective agreements, directives by the professional associations). Moreover, labour law is more strongly influenced by precedents (case law) than other areas of jurisdiction. This applies in particular to collective labour law and to →*industrial action*, which is not legally regulated. For disputes between those involved, the labour courts are responsible.

Collective legal agreements can also be reached through a conciliation procedure. For approximately two-thirds of all collective agreements, conciliation procedures are mediated between the →*social partners*, which are supposed to contribute to the out-of-court settlement of conflicts of interest. However, agreement suggestions submitted by arbitration boards are not binding. Some individual German states have a conciliation procedure, which is also not binding for the partners in a wage agreement.

Initially, labour law was mainly intended to protect the worker against prejudice, economic disadvantages and occupational hazards. Today it is focused on a more comprehensive organisation of all aspects of working life. State legislation is merely setting minimum standards, such as maximum permissible working hours, paid minimum leave, terms of notice and continued salary payment in the event of illness. In all other respects, it is up to the parties concerned to adjust working conditions to their needs, specifying above all the type and extent of work, the level of remuneration, vacation entitlement or potential extras.

For most industries, working conditions are regulated by collective agreements, which in principle are only binding for the companies belonging to an employers' association and representing one of the parties to the agreement. In terms of the law, a collective agreement only pertains to the members of the tariff-bound trade unions, even on the part of the workers; in fact, however, the regulations apply to all workers. Apart from collective wage and salary agreements, there are numerous agreements regarding extras (e.g. leave pay, continuation of wage payment, benefits for private capital accumulation).

Both collective agreements (between employers and trade unions) and plant agreements (between employers and works councils) can be finalised at company level. Collective agreements and plant agreements have immediate validity and do not require contractual form in the case of every employee. But at the same time they cannot override national law. In all

other respects, the favourability principle applies to the workers: any regulations over and above the collective agreement or the plant agreement concerning them have to be advantageous.

The fast pace of change in the working world – the development of new branches of industry, a growing services sector, the decline of the traditional areas of production, a lower level of organisation on both sides of industry – keeps labour law in constant flux. Both the autonomous regulations of the parties involved and case law ensure that adjustments are up-to-date and practical.

Besides, international legal sources are gaining increasing importance. Agreements by the →*International Labour Organization* become binding only when they have been ratified and converted to national law. Usually, however, German legislation is already in step with the respective agreement at the time of ratification. By contrast, →*European Union* regulations have a more direct impact on the national labour law – especially guidelines on gender equality (regarding remuneration, vocational training, job access and working conditions), work time organisation and minimum leave. European works councils or the EU Directive on the Posting of Workers are of seminal importance.

The 1989 Community Charter on the social fundamental rights of workers as well as the memorandum attached to the Maastricht Treaty and the agreement on →*social policy* also contribute to the ongoing adjustment of minimum labour law standards in the member states. Due to the high density of European legal regulations, harmonisation in the realm of technical



industrial safety has progressed particularly far.

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### Labour market order

The conception of the →*social market economy* intends to marry the economic efficiency of a liberal →*market economy* with social protection and balancing (Alfred →*Müller-Armack*). In terms of the theoretical background of this conception, the traditional 19th century solution to the problems of the worker through →*social policy* has become a central concern of the economic and social order.

The conception of an economically efficient but equally 'socially fair' and humane competitive order was described in great systematic detail, particularly by Walter →*Eucken*. It embraces a group of constituent and regulating principles that are to be understood as a unit, and that also represent a specific type of labour market organisation. The specific labour market organisation of the social market economy is aimed at solving the problems posed by the historical social question. The labour market organisation, by forming an integral part of an organisational conception open to the future, must however also show openness

towards future developments in the area of gainful employment.

Early on in the industrialisation phase, a capitalistic free market economy devoid of any form of checks and balances, combined with an enormous surplus of labour, led to the phenomenon in the working class of what has been called 'proletarity' (Götz →*Briefs*). The first reaction to this was the national prohibition of child labour. At the same time, labour market regulations, which initially seemed to go against 'the interests of the economy', were found to result in greater prosperity in the long run (both macro- and micro-economically).

Despite continually high levels of →*unemployment*, a shrinking and ageing population (as in practically all highly developed countries) means that 21st century Germany is faced with the spectre of a shortage of available labour. It is true that the radical, historic change from a surplus to the scarcity of (at least marginally qualified) labour prepares the ground for the implementation of the items on the agenda of a socially-minded government. On the opposite side lurks the danger of market failure or unsatisfactory welfare interventions in the labour market.

Notwithstanding further advances regarding the qualifications and independence/coming-of-age of workers, or rather →*managers* of their own human capital, a minimum of special regulations in the employment sector is indispensable for the following reasons:

- For the majority of employed persons and households, earned income remains the dominant basis of existence, so that once again an asymme-

try of power between supply (workers) and demand (business) in the job market, and also an anomaly of supply (increase of available labour with decreasing remuneration rates) can be detected. These abnormalities are the reason why officially binding rules governing wage determination in the labour market are necessary and why certain groups require special protection.

- Apart from the usual personal risks (health and the need for nursing care, disability, old age), the collectively interdependent risks of unemployment or a lack of orders in the event of an economic, structural or growth crisis, persist.
- Work is not a uniform 'product' but is characterised by differences in qualification; certain forms of work and their rewards can only be roughly defined in a general work contract. Despite the possibilities of modern information and communication technologies, a labour market in its entirety (which exists as a mental construct only) will never be completely transparent and comprehensible.
- People have to choose occupations and decide which qualifications to get, without knowing under what conditions and for how long they will be able to use them. This is why prudent workers and businesses will only invest adequately in the acquisition of qualifications (human capital) in times when a certain stability of the conditions of employment prevails.

For these reasons, it is likely that in

any economic system with free and equal citizens, a minimum of regulations would emerge in the work sector, and, due to the economic advantages for both sides of the market, that it would also persist.

On the basis of the right to free personal expression, equality before the law, the right to private property, freedom of trade, the right to free speech, the right to free choice of occupation and place of work, and also on the basis of the national responsibility for an overall economic equilibrium, the labour market organisation in Germany could be built on five columns:

- The autonomous wage bargaining (collective industrial law), which according to the subsidiarity principle leaves the agreement of minimum standards for individual employment contracts to the bargaining parties involved (trade unions, employers' associations, →*social partnership*). In collective bargaining, a conflict of interests and distribution is assumed. Therefore, the bargaining parties are (apart from the obligation to keep the peace) entitled to the free management of their interactions, even up to the point where they resort to →*industrial action* (strike, lockout) as a last weapon in the conflict. Collective agreements are binding for members of the two sides of industry; deviations are only possible in favour of the worker (favourability principle). Whether negotiations are conducted in a centralised or decentralised manner, and also the degree of differentiation and flexibility of the collective agreements, depends on the aims and statutes of the trade unions and the

employers' associations as well as on the →*collective agreements*.

- The desire to overcome the situation of the worker as an object within the modern labour organisation is achieved by worker participation at management level (→*co-determination*) and in the company as a whole. In contrast to the relationship in a collective agreement, the relationship between the works council and management strives to maintain trust and cooperation. Plant agreements can fill in the blanks left by the bargaining parties (opening clauses) in terms of company requirements.
- Apart from tariff standards, legal worker protection standards (e.g. for severely disabled individuals, children and adolescents, maternity leave; protection against unfair dismissal, work time protection, minimum leave; occupational hazard and health protection) reinforce tariff standards and areas of occupation which lack organisation, downwards (often more favourable tariff standards apply upwards, *vide* worker protection).
- The →*Federal Employment Agency* is an institution which serves the labour market by communicating information, offering career guidance and as an employment agency. It also promotes the acquisition of further qualifications and supports mobility, and through all these measures helps to even out imbalances between supply and demand in the labour market.
- In the event of unemployment, unemployment insurance prevents

social degradation (since the abolition of the obligation to accept unreasonable job offers), through payments of wage compensation (unemployment pay, unemployment relief) and by taking care of pension and health insurance contributions (→*unemployment: social security*).

Labour market organisation has been codified in the collective and the individual sectors of industrial law, and is constantly progressing in the light of legal precedents and innovations introduced by the two sides of industry. In this way, it was and continues to be possible for the two sides of industry to develop, without outside interference, much of the increased complexity and flexibility of collective agreements which the economic literature calls for.

The organisation of the two sides of industry was set in motion more and more by the transformation of the categories of occupational structures and also through processes of corporate organisation.

The fact that today neither workers nor employers are automatically prepared to join labour organisations (in particular in the new German states), combined with the increasing importance of new forms of independent gainful employment, will cause further adjustments of the institutions and new forms of labour market regulations.

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## Labour market policy

### *Labour market policy from the economic perspective*

The ability of the labour market to function and the motivational structures of those involved in the labour market are restricted by complex sets of rules, above all the collective agreement law, the Industrial Constitution Law, the co-determination regulations, the protection against unfair dismissal regulations as well as the regulations for unemployment benefit and the social security assistance rules.

The German labour market regulations prefer collective over decentralised and company-friendly regulations for wage and working conditions; it supports and protects the collective (i.e. focused on federations) controlling power of trade unions and employers' associations.

Through this market structure, →*competition* on the labour market is strongly limited so that spontaneous processes of correction, which are usually caused by price reactions in the markets, are blocked.

Just as order frameworks aim at promoting a workable competition in markets, labour policy should aim at improving the transparency of the labour market, the mobility of the economic agents, wage flexibility and the

other conditions responsible for a functioning labour market. It thus concerns the entire institutional-legal set of rules of the labour market, which represents the framework within which employees and businesses have to make their decisions.

In terms of legislation, labour policy (in the economic sense) should focus its measures on the limitation of federation-oriented control by promoting outsider competition (for example, by giving individual and collective agreements equal standing in terms of the collective agreements law). At the same time, it should improve the incentive structure in the social security system through reforms leading to increased flexibility and adaptability, with the goal of giving the individual employee more scope (e.g. concerning wages, working hours and geographical and sector-related mobility, as well as mobility in terms of training and qualifications).

This is necessary in order to mobilise market forces and for their potential to reduce →*unemployment* and increase →*employment*.

### *Labour market policy in the literal sense*

It must be said that labour market policy tends to be interpreted too narrowly and is often limited to repair measures on the part of the authorities. These look for specific characteristics if and when unemployment already exists.

A difference must be made between passive and active labour policy. While passive labour policy basically aims at stabilising the financial situation of unemployed persons, it is the main objective of active labour policy to reintegrate unemployed persons who are hard to accommodate into normal con-

ditions of employment. This eases the transition into the new job and shortens the phase of unemployment.

Both elements of labour market policy are legally enshrined in the legislation for employment promotion (Social Security Code, III). Making both elements of labour market policy a practical reality is the task of the →*Federal Employment Agency* in Nürnberg. Regarding labour policy, the Federal Employment Agency has the following areas of responsibility: career guidance; the provision of places of work and training; guidance leading to better employment opportunities; and other forms of promoting work integration.

The instruments of the passive labour policy are: unemployment pay, unemployment aid, short-term money, insolvency allowance and winter bonus. The instruments utilised by labour policy are: job creation measures; promotion of →*vocational training and further education*; training measures; support of consultation and provision; mobility assistance; integration subsidies; assistance to establish self-employment; staff employment subsidies for new businesses; the fight against long-term unemployment; integration contracts; and the promotion of structural adjustment measures.

#### ***Criticism of income loss compensation***

The high level of unemployment and the growing likelihood (in the future probably) for many employees of becoming unemployed once, or even several times, during their working life, highlights the need for an adequately conceptualised unemployment insurance. This should permit the employed

to minimise financial risks from temporary unemployment and to bridge the gap until they find a suitable new job, without having to fall back directly on support benefits which are funded by tax money.

The striking (negative) effect of the duration and level of income compensations, particularly on the attitude of individual employees and/or unemployed persons and on that of the bargaining partners, has attracted criticism. It makes them reluctant to hold back wages and it makes them less adaptable. Economists call such behaviour moral temptation (moral hazard). In order to avoid this it would be helpful to strengthen the insurance character of the unemployment insurance, which means that duration and level of the payments would depend on different rates of contribution. This would mean that employees and workers who do have a job would continue to be subject to compulsory insurance, but at the same time they would be free to choose between different payment options.

#### ***Effectiveness and efficiency of active labour policy***

An evaluation of active labour policy meets with substantial statistical problems since important data of economic research are not generally available. The Federal Employment Agency assesses its activities on the basis of indicators, which show how many participants have been taken off the unemployment register six months after completion of a measure (remaining ratio), and also of indicators giving the percentage of participants who are working a certain time after the completion of a measure (integration ratio).

In the opinion of the →*Council of Experts* for the investigation of overall economic development, the remaining ratio says nothing about the fulfilment of the actual requirements of the labour policy, and thus about the transition of persons to a regular occupation or about the improvement of their re-employment chances, since participants may also (e.g. because they lost the courage) have quietly withdrawn or gone into early retirement.

For neither of the two indicators has a comparison been drawn with persons who after a period of unemployment, found a new job without participation in a labour policy measure. Besides, in the opinion of the Council of Experts they do not give any indication as to the effectiveness of a measure, i.e. whether a less costly integration process might have been possible.

Studies on the effects of the promotion of →*vocational training and further education* and job creation measures are either focused on the micro level and the individuals concerned and on control groups, or on the economy as a whole.

Regarding the measures promoting skills training, the outcomes are predominantly negative; it is frequently seen that as a result of these measures the individuals concerned find themselves in a job market situation which is worse than before. Only for certain special groups, such as people with very few skills, is this labour policy measure associated with a better chance of finding employment.

Outcomes of job creation measures are so far only available in the form of individual data, and thus at the micro level, for former East Germany where

on account of the dramatic employment break-downs they were applied with particular frequency.

According to these data, participants in these measures are less likely to find a new job than non-participants. If positive results are noted, it seems probable that this is due to an impending expiry of benefits rather than to the participation in the measure. It seems obvious that the individuals concerned only make renewed efforts to secure a job when their financial support is coming to an end.

Macroeconomic investigations (involving all of the economy) on the whole paint a slightly more positive picture: in the majority of cases, job creation measures have been associated with a decrease of structural unemployment. Measures for the promotion of vocational further training have been credited with a lowering of regional long-term unemployment.

### **Conclusion**

It is widely accepted that government interventions are guided by the principle of helping the unemployed to become more competitive in the job market rather than merely to assist them financially. This general argument forms the basis of active labour policy.

Labour market policy will also have to persevere in its attempts to make the integration into the regular job market easier for the unemployed. This is particularly urgent in the case of people who are affected or threatened by long-term unemployment. But it must be taken into account that not everyone has the talent or the will to gain vocational qualifications or to retrain, and some qualifications will not be what the

job market actually needs. Job creation measures cannot provide new, lucrative jobs; they can, on the contrary, have a depleting effect, which is one of the problems facing normal occupation in the private sector.

The Organisation for Economic Cooperation and Development (OECD), the 'think tank' of the industrialised nations, has spelled out in its reports on the different countries that active labour policy measures tend to lack detailed planning, effective implementation as well as satisfactory supervision.

It became apparent that the most effective measures are specifically tailored for and focused on groups sharing similar occupational problems. Their content and methodology should be clear and precise in design and must be implemented in a strongly work-oriented environment.

By contrast, large-scale training programmes taking place in a class-room setting and aimed at adults with little training or long-standing unemployed persons did not yield much success. In addition, measures aimed at adolescents suffer the drawback that young people who drop out of school are not easily motivated in a class-room environment. Wage subsidies for the private sector and temporary occupation programmes in the public sector are often accompanied by depletion effects, administrative inertia and problems of stigmatisation.

In order to become more effective, state employment agencies should be exposed to competition with private and municipal institutions. Consistency of execution can be improved through the implementation of plausible sanc-

tions. This should at least prevent the use of active labour policy measures as a vehicle for renewed claims of unemployment pay when, really, they should be an instrument for successful integration into the official job market.

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## Liberalism

The political and economic concept of liberalism (Latin *liberalis* = that which is appropriate for the free man) goes back to the Enlightenment Era and became very popular during the 19th century. Those who pursue liberal ideas seek to establish a liberal system in which the individuality of each human being can be expressed and utilised in the social and economic division of labour. The state has been given the supreme responsibility to protect the civil rights and liberties of its citizens. The traditional, formal distinction between political and economic liberalism considers these two spheres as entirely separate from each other and misjudges the common elements.

Aristotle (BC 384–322) is one of the early thinkers of antiquity and at the same time a forerunner of political and economic liberalism. He sees man as a *zoon politikon*, a social creature, but at the same time part of a political system characterised by the ideal of individual liberty and equality, and ruled by a law established by man himself.

The early liberal movement had its beginnings in the 16th century with the Enlightenment and the Renaissance as a ‘demand for liberty in relation to the state’ (Alfred →*Müller-Armack*). John Locke (1632–1704) postulated a social contract as a constitutional government for the protection of private property (→*property*). Civil laws (the rule of law) and the spontaneous behaviour of people were supposed to shape human actions and make them appropriate for the respective situation.

One of the early representatives of a spontaneous, evolutionary order was David Hume (1711–1776). Adam Smith (1723–1790) with his major work *The Wealth of Nations* and Jeremy Bentham (1748–1832) with the formula ‘the greatest happiness of the largest number’ (of humans), make the transition to the classical political liberalism of the late 18th and 19th centuries. German liberalism is based on the contributions of Kant, Fichte and Humboldt. French liberalism – represented by the idea of the tripartite powers of the legislature, executive and judiciary – is represented by Voltaire, Rousseau and Montesquieu (1689–1755).

The Declaration of Human Rights in France (1789) signalled the beginning of classical liberalism (high liberalism) and in the 19th century led to the

introduction of liberal constitutions, characterised by greater rights for the common people and liberal economic systems, particularly concerning international trade.

In the late 19th century, the shrinking membership of the liberal parties, reactionary currents and workers’ movements led to the displacement of liberalism. Disappointments about the effects of an economic policy of ‘laissez-faire’ and the illusion of a naturally self-generating economic system led to the splitting off of economic liberalism during and after the First World War. Political liberalism, in contrast to economic liberalism, was converted to a policy of interventions and a commercial policy of protectionism.

On this basis of →*interventionism*, particularly Ludwig von Mises and Max Weber developed the intellectual basis of neo-liberalism, which encompasses a broad range of ideas and values for a liberal political and economic order on the basis of a →*social market economy*. Out of it grew the ordo-liberal Freiburg school with Walter →*Eucken*, William →*Röpke*, Alfred →*Müller-Armack*, Franz →*Böhm*, Alexander →*Rüstow*, Ludwig →*Erhard* and others, who in the final result introduced the social market economy as a modern economic system into Germany.

As a delimitation from classical liberalism, the ordo-liberal school also introduced the term palaeo liberalism (= old liberalism), which can be described as a consistent form of liberalism with minimum state interference and without a social element (as it seemed desirable during the heyday of capitalism in the 19th century). Friedrich August von →*Hayek* elaborat-



ed on the idea of a spontaneous, evolutionary order and, like Karl R. Popper, the concept of an 'expansive' or 'open' society with a liberal democratic constitution. The idea of the social contract enjoyed a revival through John Rawls, Robert Nozick and James McGill Buchanan. The Chicago school, of which Milton Friedman is a member, has strong neo-liberal tendencies.

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Ralph G. Andereg

## Managing and planning

Human and material factors of production – especially labour, land and capital – are required for the production of material goods and services. However, both human and material factors of production are quantitatively and qualitatively limited (natural resources); they are scarce. This equally applies to products made with them. In many cases, however, the factors of production can be used for the production of completely different goods in an economy based on division of labour.

This brings up the question of how the degree of scarcity of the individual factors and products is best identified, and how limited quantities of these factors can then be channelled to the best

possible locations so that at any point in time all the individual processes in the division of labour work together harmoniously, regarding material, time and space. This coordination must be organised in such a way that eventually, and with minimal environmental impact, finished products result, which in terms of their nature, quality and quantity assist people to the greatest possible extent in the realisation of their personal, family and collective objectives (the economic problem of control and allocation). The solution to this problem requires careful planning – prior to the actual implementation – of how the factors ought to be utilised in each separate step of the divided labour process.

In terms of the detailed planning of production and goods exchange, the question of who should ultimately take the planning decisions can, looking at past experience, be answered in two essentially different ways:

- Planning decisions are made in the context of the hierarchy of government authorities and concern the economy as a whole. When this happens, the entire economic outcome based on this process of planning is mainly aimed at the objectives, which are of importance to the upper echelons of this hierarchy (central economic planning). They try to gain the information on which their planning decisions are inevitably based through reports extracted from a network of bureaucratic communication channels, and to achieve coordination by way of directives. This form of economic planning entails a number of serious informational and motiva-

tional problems (→*socialism/planned economy*).

- The divided labour process, by contrast, is planned independently and with no official directives in the individual economic units – i.e. enterprises, private households and autonomous government departments – regarding quantities and prices for individual products and factors of production. More especially, its planning is based on relevant information about the economic environment. The plans are tuned to the goals that the economic agents are pursuing at any particular time. The instruments for the acquisition of information and the coordination of the single plans are the exchange and price formation processes in the markets of the factors of production (→*labour market system*) and of the products (= decentralised economic planning; →*market economy*, →*markets and prices*).

The term economic planning is also used in another sense. Apart from the direct planning of the use of factors of production for the production of goods, there are also forms of planning which refer to the political activities of the state. These are the attempt by the state to shape the →*economic order* by setting up legal rules (institutions) which have an influence on the economic actions of people (→*institutional order policy* – *Ordnungspolitik*). On the other hand, the state also tries to find ways of directly influencing the economic process (→*process policy*).

Legally, in process policy a distinction can be made between planning

based on administrative law (e.g. the planning of transport routes and construction) and planning based on state law (e.g. educational and defence planning). The latter form of planning can, for the purpose of achieving political objectives, mean that the plans merely serve as information on politically desirable goals and as motivation to others to contribute to their implementation, without being binding for the authorities or even for private citizens (indicative plans).

But the planning that is binding for authorities and private citizens greatly restricts their room for manoeuvre in their own planning (imperative plans). Here, the boundaries of the market economy are getting blurred (decentralised economic planning).

When government planning affects increasing numbers of sectors of the economy, and when the government attracts more and more means through taxation, the political planning of economic activities moves increasingly in the direction of a centrally planned economy (→*state revenue*).

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Gernot Gutmann

## Market economy

‘The key element of economic acting is man.’ This means that the economy is supposed to serve humans and not the other way around.

How do we know whether the economy serves humans?

We look at humans in their role as consumers. They did work and were remunerated for it; now they want to look after their personal needs. If they have to search and wait for a long time, only to return home with nothing or having bought something of inferior quality, then the economy is not serving humans.

Inferior goods and long queues were the economic norm in the practical form of  $\rightarrow$ *socialism*. Here we encounter the paradox that this economic and social system should have been specifically designed with people’s needs in mind, but in reality the opposite was the case.

In the market economy, fluctuating prices signal the scarcity of goods to consumers and producers. If the demand for goods also changes, then their relative price (exchange value) changes: the product more highly in demand is sold more expensively – measured in units of goods now less in demand – and vice versa. This is how producers gather information about the purchasing intentions of consumers. On the one hand, relative price changes make it worthwhile for the producers (rising prospects of  $\rightarrow$ *profit*) to produce goods that are now more strongly in demand, while on the other hand the production of other goods declines; the people who produce them will change their methods, i.e. either by trying to

work more productively or to move to more profitable areas.

The main prerequisite for this is private  $\rightarrow$ *property*, which can be defined as the right of private actors to dispose of goods and services. These private actors also have to accept the consequences of their own decisions by being liable – positively in the form of profits, negatively in the form of losses – and, in extreme cases, this can mean bankruptcy. A successful market economy without bankruptcies does not exist.

Since in a market economy, production is structurally flexible and can adapt – through prices as information signals and prospects of profit as incentives – to the desires of the consumers (consumer sovereignty), we encounter the paradox that although this system was not specially designed for the fulfilment of human needs, it does exactly that.

Adam Smith (1721–1790), the theoretician of the market economy, sees the individual producer in a market economy as being led by an ‘invisible hand’ and generally serving (‘frequently’ in the English original) a purpose (improved supply of goods) that was not originally his intention. It can be demonstrated that the market economy promotes economic and social prosperity because  $\rightarrow$ *competition* urges, and sometimes even forces, the actors to find better solutions in order to survive the competition, and also that in this way superior products and production procedures are perfected and distributed (competition as process of discovery: Friedrich August von  $\rightarrow$ *Hayek*).

A market economy and competition are also instruments of power control and as such they help to protect indi-

vidual liberty (Franz →*Böhm*). The market economy even teaches good morals – in the context of the economy. The exchange of goods and services in the market, as well as the possibility of a drift, force the producer to be honest: the promise to render a service and its fulfilment need to overlap. If the buyer can trust the promise, the buyer will remain loyal to the producer; if not, the buyer will go elsewhere. This forces the seller to be reliable and punctual. Computer experiments even show the following: ‘honest’ behaviour (overlap of service promises and fulfilment), as long as the exchange partner is also honest, becomes the norm even in dishonest population groups. If fraudsters do business with other fraudsters and everyone can be cheated, nobody knows if they are going to derive any net benefit at the end of the day. It therefore makes sense for fraudsters to look for deals with honest partners and give up fraud; this will save them the high information and transaction costs. The paradox is therefore that market economies generate and reinforce morality by allowing individuals to pursue their own interests, while it is often lost in the attempt to divert individuals from their real interests and train them to work directly for the common good.

The theory that a market economy educates the actors to act responsibly certainly applies only in the continual give-and-take of mutual actions. Sellers want to fulfil buyers’ expectations and vice versa because they want to ensure a continued business relationship. But if the sellers do not depend on the satisfaction of their customers because they are closing a deal that will either never be repeated or will be final (e.g. the sale

of a secondhand car), then the buyers must realise that they may be deceived.

Certainly, reliability and ethical (business) practices are exclusively or mainly restricted to an environment regulated by the principles of a state under the rule of law (governments under the rule of law). Otherwise the cancer of corruption has to be expected. Corruption is levelled against producers and consumers and enriches those who break the law with impunity. The creation of a political system under the rule of law is in turn the consequence of a liberal institutional order (the highest cultural achievement that one people can make: Franz →*Böhm*).

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### **Market economy and public institutions**

The →*market economy* requires a stable legal-institutional framework which the state can create by making provision for internal and external security, administration of justice and a suitable infrastructure. The framework is achieved through a predictable and reliable public administration, working in the con-

text of tried and tested legal rules, which can be changed only after careful examination. The police and the judiciary, for example, are quite active and agile within these rules. Independent courts can investigate whether the rules are being observed. This does not hamper the economic process but it provides a system for avoiding rule infringements. The more economically government tasks and administration are assessed, the higher the standards which the government can apply in the selection of its officials, as long as it offers competitive salaries.

The modern  $\rightarrow$ *welfare state* wants to control the economic process through 'interventions' ( $\rightarrow$ *interventionism*) and its own economic activities, but it gives up the principle of continuity if it tries to adapt to the continually changing economic conditions. Formally, the market is maintained while the state is constantly changing its rules with the result that investments and the competitive process become ever riskier.

The constitutional state and the division of power are outwardly maintained, but legal regulations are becoming ever more numerous, complicated and short-lived. The legislator who cannot live up to the increased demands which accompany the planned fine-tuning of the economic process is delegating (as in the  $\rightarrow$ *European Union*) a large part of the law-making to the executive. To have to learn new regulations is laborious and expensive, not only for the economy but also for the administration. What was legal and brought  $\rightarrow$ *profit* yesterday has become illegal and loss making today. Citizens' plans are less secure; their feeling of right and wrong is decreasing and, in

equal measure, their understanding of how to apply the law is diminishing as well. The administration is setting the norms and playing the role of referee in the market as well as being a privileged fellow player who can hide its own or others' economic mistakes by changing the rules. The need for supervision makes additional quality demands on administrations, which become inflated and have to resort to less-talented public servants. The increasing specialisation of departments requires coordination of the smallest decisions. This is how policy deprives the market of its control functions. In the same way as  $\rightarrow$ *social policy*, extensive public provision for subsistence is also becoming more unpredictable.

In a centrally administered economy, the economic process is seemingly less complicated in that it is directly controlled through comprehensive state planning ( $\rightarrow$ *planned economy*). A general judicial examination of public administrative measures is excluded, since otherwise the central control of the economic process would become impossible. An interruption while a final judicial ruling and new plans are passed would be unacceptable.

In a planned economy, the division of power and the constitutional state are replaced by the duty to obey organisational rules and, if absolutely necessary, the possibility to make a complaint. To that extent the administration has more room for manoeuvre. But it has none of the information that the market would otherwise have supplied. It is tied to rigid planning and suffers from a fear of risk-taking, which is typical of the lower government departments. Only at the expense of other goals and under

political pressure and one-sided concentration of means, can it be motivated to excellence (for example, space travel) in certain areas (→*socialism*).

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*Hans Willgerodt*

### Market mechanism

When economists discuss theoretical problems they frequently use the term 'mechanism', particularly in the phrase 'market mechanism'. If it is not used with care, however, the result can be that the underlying processes are not properly understood. The association with 'mechanism' links market processes to mechanical operations, which are characterised by a predetermined relationship between cause and effect.

The outspoken opponents of a free market system (→*socialism*) and other critics who demand that economic activities should adhere to ethical principles and goals (→*Catholic social doctrines*, →*Protestant social ethics*) have accused economics in both its scientific and practical forms of being mechanistic and materialistic.

As a concept of economic and political struggle, these accusations are often subsumed under the keyword 'neo-liberalism' (→*liberalism*, →*social market economy*). But economists contribute to this distorted view if they do not sufficiently explain the principles of economic processes and decision-making. In addition, the fact that economics has

become so overly mathematical might have contributed to the fact that the great variety of causal relationships, as well as all the acting participants involved, can no longer be seen clearly.

Since it is extremely difficult to isolate an economic cause-and-effect relationship due to the enormous complexity of economic processes, economic theorists strip them, for the purposes of analysis, of all other (actually existing) factors by accepting these as unchanged and leaving them out of the equation (subtracting these factors). In the case of such highly abstract theoretical models, it is possible to show in a graph how an economic entity (e.g. demand) changes if one component (e.g. price) is altered (→*supply and demand*). Graphs of this kind are used particularly in economic theory, but frequently without a clear explanation of the parameters on which they are based.

This is obvious in the case of *homo economicus*, a virtual participant in the economy. They only act in economic categories and their objectives are fixed (e.g. needs maximisation as a consumer, profit maximisation as a producer). Such assumptions allow clear solutions (statements, results) in certain model situations.

This type of procedure is in some ways directly analogous to laboratory tests in other scientific disciplines and helps to clarify fundamental relationships. It is only in these theoretical models that one can talk about mechanisms, but not when one is dealing with actual people in the real world (of economics). The actual life in a society and the behaviour of real people in the economy can only be partially captured by models of this sort. Nor does it

become sufficiently clear that models based on assumed behaviour lead to solutions that can be considered as the norm, but that the solutions change if a different behaviour pattern is assumed and this is then regarded as the exception to the rule.

Accordingly, it is the norm that there is less demand for a certain product when its price is going up (regular effect). Notwithstanding this reaction of the majority of the buyers, however, someone may decide to do exactly the opposite and to demand more of this product precisely because only few people are able to afford it (snob effect). This reaction is definitely the exception, seen in the light of the regular behaviour of the 'normal' consumer. This can even be due to a rational decision, if all buyers want to have more of a certain product despite increasing prices. This is significant if all buyers proceed from the expectation that the price will continue to go up. In such a market situation, the rational and normal decision would be to demand more of a product in order to avoid the anticipated further price increases, if one cannot live without it.

It is becoming obvious that economic theory is behavioural theory. The factors affecting the behaviour of economic agents in relation to economic circumstances vary – e.g. the market situation, the way it is perceived by the decision-maker and the status of information, objectives and interests of the acting subject, and many other issues. The eventual decision depends on all these factors. The participants are always people who are acting either on their own behalf or on behalf of others (parents for their children, →*entrepre-*

*neurs; managers* on behalf of their enterprise or its owners, trade unions for employees, politicians and state officials on behalf of the citizens).

If individuals are acting for themselves as consumers or sole traders, their interests are clear. In the case of people who act on behalf of others as their representatives, it is more difficult to determine which issues should take priority in the decision-making process – e.g. the interests which the acting subject attributes to the represented group or institution or their personal self-interest (→*institutional economics*).

All economic agents, enterprises and institutions act through people. The perception of the individual on which economic theory has based its assumption of behaviour, is the mature citizen who acts rationally with his/her economic interests at heart. Limits are imposed on their actions by written and unwritten rules, and moral and ethical standards.

Even if the market-players take each case at face value, forecasts of the behaviour of market participants under standard conditions are nevertheless very reliable. Human behaviour has been empirically observed over centuries – it is therefore safe to make certain basic statements about patterns of reaction which form the background for reliable rules and predictions.

Economic findings and instruments are also usefully applied in other social sciences – e.g. in political science and scientific social research. And yet, one is not really describing a mechanism in the true sense of the word since many different people take different decisions under ever-changing circumstances. This should never be forgotten if mis-

understandings and misinterpretations of the term 'market mechanism' are to be avoided.

*Hermann Schneider*

## Markets and prices

The market is the place where  $\rightarrow$ supply and demand meet. Exchanges are agreed. In the goods markets, consumers (as buyers) exchange money with the enterprises (as seller) for consumer goods. On the factor markets, the enterprises (as buyers) acquire the factors of production and material capital in order to use them for the production of consumer goods. Beyond this, there are special markets – e.g. for loans (the offer of money in return for interest payments from the buyer of the loan), for foreign exchange (offer of a national currency in exchange for another currency) or for stocks and shares (through the buying and selling of shares).

The fact that supply and demand change over time is characteristic of most markets. The demand for certain goods can increase, if private  $\rightarrow$ incomes rise or if other consumer goods go up in price. Certain goods can be in greater supply because the factors of production are becoming cheaper, with the consequence that more enterprises enter into production.

Such changes mean that despite the fact that the market always appears to be on the verge of reaching equilibrium of offer and demand, actual market equilibrium is achieved only rarely. Both buyers and sellers tend to be unsure about the exact market situation. A con-

tinuing search and discovery process therefore takes place in order to find the best possible deals in the markets. During these market processes, enterprises that are innovative and dynamic and do not shy away from risk usually have particularly positive results. They offer new products and also open up new markets.

Initially, sellers of a new product are alone in the market and have a monopoly. As they have no direct competition, the monopolists can charge relatively high prices. Market supplies can be arranged in such a way that (maximum) monopoly profits are made. As soon as other enterprises take up production, this changes. A small group of sellers forms an oligopoly. Such a market can generate particularly intense  $\rightarrow$ competition. Every action a seller undertakes (e.g. a price reduction), affects the market success of the few competitors so strongly that these competitors react immediately with a price reduction or another improvement to the supply.

If, however, very many sellers are active in a market, the decisions of one single enterprise are hardly noticed by the others. Here one is dealing with a polypoly, where an individual competitor is only one of many and cannot affect prices. His products have to fit in with the market price, which in turn is the result of the anonymous interaction of total offer and total demand.

Whether new sellers find it difficult or easy to enter an existing market also has an impact on market development ( $\rightarrow$ open market: market entry, market exit). Market entry can be obstructed, for example, because the established enterprises are the only ones to have the necessary factors of production (such as



highly qualified employees), or because they have developed a close relationship with their customers. If the market entry is problem-free, even a monopolist cannot charge hyper-inflated prices, but he/she must always count on the fact that new enterprises (newcomers) with lower prices could displace him/her. Such markets become more competitive due to potential competitors waiting in the wings for their chance to enter the market. Thus the incentive and control effect of the free market remains.

In addition, the monopolist is hampered by the fact that the buyer could go to the sellers of other goods which satisfy their needs equally well (substitution goods). For such decisions, the relative price difference between the different products is important. At the same time, consumers do not always regard different products as exchangeable, so that this market process becomes only partly effective. A buyer of domestic products can also move on to foreign goods if there is free international trade.

Besides, the markets not only determine the price of a certain product; the success of an enterprise also rests on other characteristics of the products on offer, apart from the price. These include, above all, the quality, but also the sale and distribution of the goods, the service offered and often the way they are advertised. The sellers must therefore strive to satisfy the demand as best they can with a favourable combination of characteristics.

Normally the supply in a market increases if prices go up. However, this does not apply to goods which are in limited supply (e.g. paintings by a

deceased artist) and cannot be increased. In such cases the price finds its own equilibrium at a level where demand and supply are just equal (price equilibrium). This has the advantage that those for whom the satisfaction of their need relative to their income is the greatest get the scarce product.

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*Hans Peter Seitel*

## Media policy

The term media policy refers to all government activities that are directly or indirectly aimed at the organisation of the national communications or media systems.

In contradistinction to the media for individual communication, such as the telephone, media policy concentrates mainly on the field of the mass media. This is traditionally divided into three categories, namely:

- press (particularly newspapers and magazines);
- broadcasting (radio broadcasting and television); and
- cinema/films.

German media policy is closely linked with the general political system. It was crucially influenced by a number

of fundamental judgments from the Federal Constitutional Court on the interpretation of freedom of opinion, as enshrined in Article 5 of the Basic Law, the freedom of the press mentioned therein, as well as the freedom to report through broadcast and film.

The main objective of the media policy is to safeguard the free formation of an opinion. Since the process of forming an opinion is markedly influenced by the opinions which the mass media carry and present, the court is of the opinion that detailed legislative measures are necessary to do this successfully. Without detailed legislation, it has been argued, there is the danger of undue influence, limitation of freedom or manipulation of the consumer by media producers.

Due to the suggestive power of moving pictures combined with their almost universal accessibility, this danger is considered to be especially great in the realm of television. As a result, media policy is especially focused on this area. Of the highest importance in this regard is the guarantee of a balanced representation of opinion across the spectrum.

Apart from special broadcasting regulations that are based on considerations for publications and their content (the protection of the youth and celebrities, the right to reply, journalistic due diligence, etc.), media policy provides an entirely appropriate framework for protection.

In contrast to the press and film industry that largely function along the lines of market economy principles, the television and radio broadcast sector is characterised by the so-called dual broadcasting system. Legally, the most

important aspect of this system concerns the regulations of the Interstate Broadcasting Agreement to which all the German states (*Länder*) are signatories. Within the dual broadcasting system, both independently operating producers and producers who are registered in the public law compete with one another. The private producers are predominantly self-financing through income from advertising or direct subscription fees (pay TV). In the view of the Federal Constitutional Court, this type of funding has a negative impact on the programme quality. In their opinion the private producers do not offer a broad variety of programmes but broadcast only programmes that are attractive to the masses and promise high ratings.

In contrast to the case of the private producers, by far the largest part of the income of the public institutions is derived from licence fees. They are exclusively entitled to them, and subscribers have to pay them regardless of whether they make use of their offerings or not.

The idea behind this is to offer programmes independently of financial obligations that also cater to minority interests. The amount of the licence fees depends on the demand submissions by the public institutions. These are examined by a group of experts (a commission which assesses the public broadcaster's financial needs) for their plausibility, and approved by the states in the context of the Interstate Broadcasting Agreement. Beyond that, the public broadcasting institutions are equipped with a comprehensive existence and development guarantee. Unlike their privately funded competi-

tors, they cannot afford to be drowned out by competition.

In return for the fee privilege, it is incumbent upon the public broadcasting institutions to ensure the population of the basic supply of radio broadcasting and television programmes. This is not merely a minimum supply but covers the entire classical broadcasting range and includes educational, cultural and entertainment elements as well.

Owing to the political independence of the broadcasting institutions, which is guaranteed in the Basic Law, the public broadcasting companies are free to determine the content of their basic programmes themselves. In order to guarantee a broad spectrum of opinions within the programmes that are actually presented, the public institutions are organised according to pluralistic principles.

Each institution has a broadcasting council for this purpose (Second Channel of German Television: Television Council). This is made up of representatives of the socially relevant groups (political parties, associations, churches, etc.) and determines, among other things, the guidelines for the programme policy.

The regional media authorities that were established by the federal states and which are likewise internally organised according to pluralist principles, supervise adherence to the content regulations of the Interstate Broadcasting Agreement by the private companies. At the same time they also licence the private producers. This includes making a selection from among the various applicants for a broadcasting licence and the distribu-

tion of the scarce radio and cable transmission frequencies.

For the private broadcasting companies, specific concentration controls for broadcasting have been established to prevent excessive ownership. In contrast to the general anti-competition law ( $\rightarrow$ concentration), not only the external growth of companies due to mergers and takeovers is supervised, but their internal growth too is limited to a maximum market share of 30%.

With a view to the future, the manner in which German media policy is organised is being questioned, particularly due to the progressive development of new internet-based interactive media. On the one hand, it is to be doubted whether the new services still represent mass media in the traditional sense and whether they have a comparable opinion-forming potential. On the other hand, the international character of digital communication media means that national media policies increasingly come into conflict with legal competence limitations ( $\rightarrow$ globalisation).

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## Middle class policy

Middle class policy is about special economic policies for the independent middle classes, which constitute 96% of all business establishments in Germany. The middle class represents a heterogeneous group; it is made up of the trades, retail, independent professions, service industries as well as small and medium-sized enterprises (SMEs) in the processing industry, up to a company size of 500 staff members.

The success of a  $\rightarrow$ market economy depends on the success of its  $\rightarrow$ competition, and this depends on the number and the competitive ability of its SMEs.

The world of politics is largely dominated by  $\rightarrow$ public enterprises or by large finance companies, with the result that many general laws have an adverse effect on the middle class:

- The same bureaucratic requirements are a greater burden for smaller businesses.
- The abuse of a dominant market position often discriminates against the middle class (e.g. supplier discrimination).
- Business owners (not managers) are the only persons in an executive position to be personally liable for the losses of their enterprise with all their assets.
- While executive salaries are listed as company expenditure, the salary of a business owner is seen as profit and is taxed.
- Only personally owned businesses

are subject to death duties once per generation.

- While international companies are able to move their profits around the world, medium-sized companies generally stay in the country, accessible to the treasury and therefore carrying more than two-thirds of the burden of public finance.

A market economy can be fair only in a climate of equal opportunity. Middle class policies are therefore supposed to protect the equal opportunities of SMEs. To this end, there are the following:

- SME promotion laws, which stipulate order volumes for public tenders appropriate for SMEs.
- The privatisation of public service sectors, which creates equal opportunities for competition in this area.
- Cartel and monopoly control, which prevents unfair practices by companies that dominate the market.
- Government business start-up loans, because SME owners without their own resources would have no access to the capital market.
- More  $\rightarrow$ deregulation to reduce the bureaucratic and administrative burden for SMEs.

The political lobby of middle class politics is less influential than the lobbies of the trade unions or big business; due to participation, employers and trade unions have formed a coalition for

their dealings with government as the agent of economic policy. Moreover, the self-sufficiency of SME entrepreneurs has made their interest groups split up. But since SMEs employ 80% of the national workforce, they could in theory go it alone and mobilise political majorities and a middle class-oriented economic policy. At present, however, there is still a lack of awareness that the interests of the middle classes are highly compatible with the goals of the →*social market economy*.

The special privileges that powerful interest groups fight for (and win) are frequently detrimental for the middle classes and their interests. This is why middle class politics continues to ask for fairness, equal opportunities and equality in a social market economy.

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## Monetarism

Monetarism was born in the 1950s, 1960s and 1970s as a reaction to the movement called →*Keynesianism*. The main representatives of monetarism include the Nobel laureate Milton Friedman (Chicago) and the economists Harry G. Johnson, Karl Brunner and Allan H. Meltzer.

Monetarism consists of the following 10 core statements:

- Inflation is always the consequence of a monetary policy which is too expansive.
- Whether a monetary policy is expansive or contractive – or rather inflationary or deflationary – can most clearly be seen from the money supply (notes, coins and short-term deposits with the banks). In contrast to this, the interest rate – above all, the long-term interest rate – is a poor indicator because it not only reflects the monetary policy but also inflation and yield expectations, the national budget policy and other things. During the world economic crisis, for example, interest rates fell to nearly zero although the monetary policy – based on the money supply – was extremely contractive.
- The central bank can control the money supply very accurately.
- In order for the monetary policy not to destabilise economic growth and →*employment*, the money supply ought to grow at a constant and predictable (previously announced) rate.
- In order to ensure that the monetary policy does not destabilise the price level, the growth of the money supply – i.e. the money offer by the central bank and the merchant banks – ought to equal the long-term growth rate of the money demand, and thus the economic production potential.
- Changes to the money supply expansion affect economic growth and employment only if these changes were not anticipated by the market

actors. But even if they were anticipated, the effects will only be temporary. When, approximately two years later, there has been a permanent price level adjustment, economic growth resumes its usual pattern.

- Changes to the money supply expansion rate tend to be largely anticipated because the market actors remember the way the central bank acted in the past.
- Like prices, wages too become adjusted to the monetary policy. It is therefore not possible to lower →*unemployment* permanently by means of an unexpected money supply expansion. The structural causes of unemployment cannot be eliminated by an inflationary monetary policy.
- If the money supply expansion rate rises again and then – partly unexpectedly – resumes a non-inflationary course, economic growth temporarily slows down, temporarily leading to the phenomenon of stabilisation unemployment. To that extent, the monetary policy cannot reduce average unemployment in the longer term, but it can be differently spread out over time.
- An unsteady monetary policy and an unstable price level are disconcerting for the market actors. They impair overall economic productivity and decrease the national income.

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Roland Vaubel

### Monetary order

The monetary order incorporates the fundamental rules governing the organisation of the monetary system in a country, such as Germany, or a currency area, such as the →*European Monetary Union* (EMU). Economies in which money is the general means of payment and means of value preservation are more economically efficient and prosperous than economies which do not use money in the process of goods exchange (barter economies). The use of money lowers the costs incurred in the exchange of goods (transaction costs) and makes a higher degree of division of labour possible, thereby leading to more prosperity (Adam Smith).

The economic advantages of money can be fully realised only when the monetary value is stable. Inflation or hyperinflation will eliminate these advantages either partially or completely. A working financial system therefore consists of regulations which ensure that the circulation of money in an economy or in a currency area is steered in such a way that →*price level stability* is guaranteed. If the money supply grows too fast (or too slowly) by comparison with the increase of goods and services

(real economy), inflation (or deflation) results. The validity of this relationship has in the long term been theoretically and empirically confirmed by numerous studies.

Metal currency systems of the past were closely tied up with rare metals such as gold (gold currency) or silver in the attempt to control the circulating money supply. Paper currency systems of today have relinquished this connection. This lowers the cost of money creation and makes it possible to control its supply on the basis of macroeconomic principles; but it increases the risk of abuse through excessive inflation of the circulating money supply for political reasons, especially when the central bank is subject to government control.

This became obvious in Germany after both the First and the Second World Wars when the central bank had been used to finance the wars, with a resulting strong currency devaluation.

This traumatic experience of the almost total loss of the entire money capital within one generation resulted in a monetary policy in the Federal Republic of Germany that was designed to prevent a repeat of this. The main elements are as follows:

- The legal obligation of the →*German Federal Bank* to focus its monetary policies above all on the stability of the price level.
- The German Federal Bank is independent from federal government rulings and from orders of other institutions (including the Upper House of the German Parliament).
- A requirement that members of the

highest monetary decision-making group, the board of the German Federal Bank, may not be called away during their period of office.

- A strict limitation of monetary contributions to public household deficits by the German Federal Bank.

This monetary system was the main reason for the fact that Germany had one of the lowest rates of inflation worldwide during the post-war era. In its practical application, it also proved its worth because the financial system and its institutions enjoyed strong public support and because it was ascertained that its rules were adhered to, so that there was a wide consensus of stability in Germany.

Due to the great success of the German monetary system, the signatories to the Maastricht Treaty agreed to use it as their model for the creation of the EMU. For this reason, all the main elements of the German financial system can also be found in the financial system of the EMU, sometimes even in a more unequivocal and strict form than in the case of the Federal Bank – for example, regarding the debarment against the financing of public household deficits.

Beyond that, the European monetary system has borrowed many other institutional characteristics from the German monetary system. This is evident in the largely identical organisational structure of the European Central Bank (ECB) (→*European monetary policy*). Thus, the board of directors – which consists of the president of the ECB, the deputy president and four other members – is responsible for the

implementation of the monetary decisions that have been taken by the ECB Governing Council. In this top financial decision-making group, besides the members of the board of directors there are also the presidents of the national central banks of the EMU member states.

Whether, thanks to this far-reaching transfer of the German monetary system to the European level the same focus on stability of the ECB will result, depends on the degree to which this new economic framework founded at Maastricht will be politically accepted. Above all, the outstanding commitment of monetary policy to the principle of  $\rightarrow$ price level stability and the independence of the ECB must be respected, the common objective of stability and growth must be adhered to, and a permanent consensus on stability in Europe must be reached.

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Wim Kösters

## New economy

The concept 'new economy' ('new economics') has not been clearly defined. Sometimes it is also associated with

concepts such as the internet economy, network economy, digital economy, e-commerce or information economy. Elements which all these terms have in common are the new technologies, above all information and communication technologies (ICT), as well as new knowledge and human capital. To put it more simply, the new economy can also be described as the ICT sector of a national economy.

What is new in the new economy? The following elements are relevant:

- ICT as new technology.
- Information as an increasingly important product.
- Higher production and growth increases due to the above factors.

It is a fact that ICT has created networks that are bringing people and enterprises ever closer together, both nationally and internationally. These networks make it possible to transmit larger quantities of data more cheaply. The resulting network effects are characterised by the fact that the greater the number of network actors, the greater the benefits for each individual actor.

The innovative aspect of information as a product within the new economy presumably consists in the fact that ICT makes information accessible faster and cost-effectively, stimulating in turn the production and utilisation of more information. The positive spin-off of this is that data-processing itself is getting better all the time. It is often said that all this can make a national economy more transparent and less volatile.

Not many sectors of a national economy remain untouched by the



increased productivity and growth that ICT and information bring as products. This is why yet another name for ICT is cross-section technology. By stimulating productivity and growth, this technology is promoting prosperity both nationally and internationally.

It is important to remember that in the new economy, the same economic principles that applied in the 'old economy' have not suddenly been abolished. The United States has, however, demonstrated more than any other country that the growth trend in the new economy can be steeper, and that the growth fluctuations tend to be less pronounced than in the old economy. At the same time, the inflation rates are clearly lower. It also seems that the economy has become more flexible and has adapted more easily to fluctuations in the market and that, as a consequence, the utilisation of the production capacities of an economy can be more even over time. This has a calming effect on the business cycle. It also means that there is less need for short-term interventions in the economic process through monetary and fiscal policy instruments.

As the mechanisms of the new economy are becoming more universally accepted, the undoubted effect is increased competitiveness of the economy as a whole. The terms 'new economy' and  $\rightarrow$ globalisation have a lot in common: they are characteristic of the progression of modern national economies towards what we call  $\rightarrow$ systems competition.

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*Wolf Schäfer*

### Nursing care insurance

Since 1995, the compulsory Nursing Care Insurance Scheme has formed the fifth column of the social security system next to the  $\rightarrow$ pension,  $\rightarrow$ health,  $\rightarrow$ accident and  $\rightarrow$ unemployment insurance schemes. Nursing care insurance was introduced because of the growing number of people in need of care. The phenomenon is closely related to the rising proportion of elderly people within the population who are not sufficiently insured for the risk of requiring nursing care. This problem had created an increasing financial burden for the social services ( $\rightarrow$ basic social security) in the form of expenditure on nursing care.

The Nursing Care Insurance Act makes it compulsory for every member of the population to be insured for the risk of requiring nursing care. Every member of the compulsory Health Insurance Scheme has to take out nursing care insurance coverage. Spouses and children who are not gainfully employed are co-insured at no extra cost. Those members of the population who are not insured through the compulsory Health Insurance Scheme

(mainly the self-employed, civil servants and employees with an income above the liability-to-insure limit) have to present proof that they have taken out a private policy, which offers the equivalent quality and extent of nursing care.

The actual execution of nursing care insurance is the responsibility of the compulsory Nursing Care Insurance Scheme, which legally belongs to the umbrella organisation of the compulsory Health Insurance Scheme, despite being financially independent. The compulsory Nursing Care Insurance is funded by income-linked contributions. Since 1 July 1996, the contribution rate has stood at about 1.7% of income up to the monthly contribution assessment limit set by the Health Insurance Scheme (2004: €3,487.50). As in the case of compulsory health insurance contributions, the Unemployment Insurance Scheme takes responsibility for the contributions of persons on unemployment benefit. Generally, half of the employees' contributions are paid by the employer. In order to lighten the load of the additional wage costs for employers, concurrently with the introduction of nursing care insurance, a public holiday (the Day of Prayer and Repentance), was phased out in all the states except Saxony.

The provision of compulsory nursing care insurance is based on the following rules: prophylactic and rehabilitative measures aimed at the prevention of the need for nursing care take preference over the services themselves. If a need for nursing care exists, care in the home environment (out-patient care) takes preference over accommodation

in a nursing home (in-patient care). In principle, those requiring care are entitled to choose between out-patient and in-patient care, and if they opt for in-patient care they are free to select one of the officially licenced institutions. However, if in-patient care is not necessary, those in need of care are only entitled to the services that are offered at the level of out-patient care. A further rule that applies to nursing care insurance is that those in need of care must make a reasonable contribution to the costs of the nursing care (e.g. by carrying the costs for food and accommodation in the case of in-patient care).

The services of nursing care insurance depend on the degree of need. This is assessed by the medical service of the Health Insurance Scheme. Those in need of care are assigned to one of three levels of care. In the case of out-patient care, depending upon the level of care, a monthly contribution of €205/410/665 is paid out for material care services (basic care and domestic work) to the value of up to €384/921/1,432 per month or a combination of these services, as well as up to four weeks of holiday replacements to the value of up to €1,432 a year. On application, the compulsory Nursing Care Insurance Scheme will take over pension insurance contributions for nursing staff in the home. The level of these contributions likewise depends on the level of care. In the case of in-patient care, depending upon the level of care, contributions in kind up to the value of €1,023/1,279/1,432 monthly and, in cases of hardship up to €1,688, are paid out.

The introduction of the compulsory Nursing Care Insurance Scheme has

substantially reduced the dependence of people in need of care on social welfare services. The choice of services available has gone up considerably – not least due to a strong increase in the number of out-patient hospital services. Due to the foreseeable →*demographic development*, if the current quality of service is to continue, one can count on the fact that contribution rates for nursing care insurance will rise in the future.

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*Albrecht Bossert*

## Occupational health and safety

The government, by setting minimum standards for working conditions through occupational health and safety legislation, is trying to realise three objectives: protecting the worker from unjustified demands by the employer; protecting the worker from self-exploitation; and protecting the worker from the actual technical dangers of the modern workplace.

Occupational health and safety legislation is intended to prevent a situation where under the conditions of →*competition* typical of a free market economy, individual choices are being turned into collective obligations: without universally binding protective standards, →*unemployment*, combined with

completely freely negotiated employment contracts, could lead to a competition for jobs among workers trying to under-cut each other, in which workers give up their right to important protective regulations in order to get work. In the short term, occupational health and safety legislation will inflate the price of work; in the long term, however, a prosperity increase can be expected, since there is a greater incentive for investment in human capital.

The legal basis of occupational health and safety legislation in the →*social market economy* is the Basic Law, in particular Articles 1 (protection of human dignity), 2 (the fundamental right to personal freedoms), 3 (the ban on discrimination), 12 (free choice of place and type of work) and 20 and 28 (→*social state* ruling).

In the course of the ongoing definition and development of occupational health and safety legislation, substantial impulses emanate from the system of labour courts, which is a special jurisdiction for questions of contracts of employment and working conditions. The Working Hours Act (*Arbeitszeitgesetz*) is supposed to ensure that the worker has enough free time for personal development. Maximum working hours and work restrictions (graded for adults, pregnant women and children), marked the beginning of occupational health and safety legislation in the mid-19th century.

In the social market economy, not all the Working Hours Act directives will benefit every worker. This is because of the far-reaching regulations of collective agreements. If, for example, according to section 3 of the Working Hours Act, the maximum

number of working hours per week is 48 (8 hours for 6 working days), within most tariff areas the number of working hours per week ranges from 35 to a maximum of 40.

Nevertheless, in the course of the 1994 reforms, the Working Hours Act was noticeably rephrased and updated, meaning that, for example, the special protective clauses of the past for female workers were largely removed for reasons of equality. At the same time, periods of compensation for extra work and rest periods were expanded. There is a general tendency to make the Working Hours Act (including the law governing trading hours) more flexible.

In the sphere of protection against unfair dismissal, the permission of limited employment contracts created a new situation through the employment Promotion Act of 1985.

The existence of a material reason justifying the limitation of the contract is now no longer necessary. It became clear that, in practice, limited employment contracts are regularly used in the public service.

In the private sector, a time limit is usually agreed in the event of a peak in orders, or the employer treats the limited employment period as an 'extended trial period'. But since over 90% of all employment contracts do not have a time limit, the regulations of the Protection against Unfair Dismissal Act (revised version 1993) are of great significance for the majority of workers. They regulate both extraordinary dismissal (without notice) and the legal terms of notice as a function of seniority.

As the protection against actual technical dangers in the workplace is

becoming more sophisticated, the mandatory →*accident insurance*, introduced as long ago as 1884 as part of Bismarck's social legislation, is playing a pivotal role. According to section 1 of the Social Code VII, its three major tasks are:

- the prevention of accidents;
- the restoration of the ability to work after an accident has occurred; and
- compensation for the insured individuals and/or the survivors in the form of lump sum payments.

The mandatory accident insurance is considered a very successful form of social security. Through a complex system of contributions, companies are offered definite incentives for prevention while also receiving comprehensive advice on accident prevention itself. From the perspective of occupational health and safety, this strong emphasis on prevention must be seen as very positive.

The role that occupational health and safety plays in a social market economy should not just be broadly assessed after the fashion of 'deregulation: solution or error?'. Rather, the effect of individual regulations on the labour market and on →*employment* must be carefully considered.

An important point of reference in a detailed evaluation of occupational health and safety would be to lay open the conflict of interests between the 90% of insiders with jobs and the 10% of outsiders without jobs. It would be inadmissible to simply ignore the interests of either of these two groups.

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Werner Schönig

## Old-age pensions

Right from the start of its conceptualisation, one of the fundamental pillars of the →social market economy was to ensure that the aged can enjoy their retirement period, adequately provided for and free from poverty. It was equally important that this long-standing old-age pension should not come across as charity, but be a rightful claim derived from contributions made during the acquisition phase. Therefore, Germany has a so-called contribution-financed pension system into which each employee deposits a fixed percentage of earned income, and from which pensioners draw during retirement in proportion to their contributions.

Unfortunately, this looks much more straightforward on paper than it is in reality. One reason for this is that it must be decided how the deposited contributions are to be used. In Germany, the deposited contributions are currently paid directly to the pensioners. In other words, this social insurance scheme works on a ‘pay-as-

you-go’ basis (current disbursement). If, however, the deposited contributions are not paid out directly but are placed into interest-bearing investments, it is referred to as working on a fully-funded basis. In this way, a fortune gradually accrues for each pensioner. The interest yields and the gradually diminishing investment are subsequently used to fund the pensions. In principle, a fully-funded pension scheme works in the same way as life insurance.

The main problem connected with the pay-as-you-go based scheme as practised in Germany – as in most other countries – is the availability of funding, which is directly dependent on the section of the population in gainful employment.

The reason is simple: pension scheme revenues are based on the contribution average, multiplied by the number of employees. Expenditure is based on the average pension, multiplied by the number of pensioners. If the number of pensioners rises or the number of employees falls (or both), it follows that expenditure goes up or revenues go down (or both).

However, the pension fund is not allowed to report a loss; if this happens, either the contributions have to be raised or the pay-outs lowered. Exactly this situation of an increased number of pensioners and a decreased number of employed persons will exist in Germany starting from approximately the year 2020.

In the year 2000, there were still about 2.0 employees per pensioner. Just looking at the statistics, in 2020 there will only be 1.5 employees per pensioner and in the year 2040 no more than one employee per pensioner. This is because

since the mid-1970s, statistically, the average woman in Germany gives birth to only 1.4 children. The resulting 'gap' in the number of employed persons could be closed only through massive immigration of at least one million persons a year (→*demographic development*).

But Germany is not alone in this predicament. The population trend is similar in nearly all industrialised countries, although in most cases it is not quite so drastic. This is why demands for the suspension of the pay-as-you-go based old-age pension scheme – the more widely practised form of retirement provision – in favour of the fully-funded schemes are frequently heard. This, however, comes into conflict with two problems:

- During the transitional phase, there will be no funding for the pensions of one whole generation. This is because if the procedure were changed over today the deposited contributions would no longer be paid out directly but would first be invested. However, if the pension contributions are no longer paid out directly, we have to ask where the funds for today's pensioners will come from. There is no satisfactory answer.
- A second problem is that the capital covering procedure is not completely independent of the population trend. The reason: the retirement insurance contributions have to be invested somewhere. One would perhaps use them to buy shares and other securities or even real estate. If one wants to 'turn these investments into money' again at retirement age, they will have

to be long-term. But by then there will be, because of the population decrease, only a relatively small number of young people, and therefore the demand for shares, securities and real estate will be comparatively small. The pension schemes will find it difficult to sell their investments to the next generation. This means they have to lower their prices, and pension scheme revenues will fall as a result, which in turn will make the pensions go down. In this way the fully-funded scheme, too, does not escape the consequences of the population decrease, although most experts believe that the consequences will be less severe.

Against this background, nearly all industrialised countries are working on pension scheme reforms. In most cases, these reforms result in a mixture of pay-as-you-go based and fully-funded schemes, more specifically based on so-called two- or three-column systems. The first column represents a reduced version of the pay-as-you-go based pension. It is intended to lower the pensions paid out of this fund gradually, giving those who are affected adequate time for adjustment. The financial losses suffered by pensioners as a result of the lower payouts are supposed to be evened out with the help of one or two further columns, both of which are constructed on a fully-funded basis.

The second column usually entails compulsory additional pension contributions to be invested. In the case of the third column, voluntary contributions are made to an investment portfolio aimed at the provision of retirement

funds and supported by government subsidies – for instance in the form of tax relief.

In Germany, there will only be two columns – a first column which is still relatively large and based on the pay-as-you-go scheme, and a second column which combines voluntary investments and government subsidies, aimed at securing a stable personal income during retirement. Taking into account the demographic development expected to start in 2020, one thing is certain: further reforms will have to follow.

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Thomas Apolte

### Open markets: Market entry, market exit

In its theoretical conception, the →*social market economy* sees competition as the key to achieving long-term economic and social progress. On the one hand, competition brings about a good market supply of goods and services (economic function). On the other hand, within the economic process, competition allows all actors the greatest possible room for manoeuvre and freedom to choose (social and political function).

A competitive system, however, which makes the achievement of these goals possible, does not develop automatically; it has to be created and pro-

tected. Attempts have been made to bring this about through a basic institutional framework (rules) which ensures that market processes, wherever possible, can take place as competitive processes.

A number of conditions or principles are of special importance in this regard. Apart from a working price system and monetary stability (→*price level stability*), the guarantee and the protection of private property (→*property*) with regard to the means of production, the freedom of contract and the liability principle (→*individual responsibility*), open markets are considered the key (constituent) prerequisite of a healthy competitive system.

There are two aspects to the openness of a market:

- There must be unrestricted market entry (no barriers to entry).
- There must also be free market exit (no barriers to exit).

Every potential actor must be given the opportunity to enter the market as a new competitor, be it due to spatial expansion, as a result of product diversification or a new product launch, or as a newcomer. At the same time, however, every established business must be able to withdraw unhindered from the market, be it for personal or market-related reasons. In other words: a healthy competitive system entails that there are no entrance barriers and no exit barriers for potential or actual market actors.

This is important because market barriers of any kind prevent the potential newcomer from having a positive

impact on market efficiency, and also because they counteract the stimulus to try harder, which arises from the latent threat of being pushed out of the market.

Free market entry and exit exercise a welcome competitive pressure on prices and costs and thus also on company  $\rightarrow$ profits. This in turn forces the producer to adopt economically rational behaviour, which aims at the most efficient use of economic resources (optimal factor allocation) and the speedy adjustment of products and production capacity. The producer must also react to external economic data (adjustment flexibility) and be prepared to introduce innovative processes, products, funding methods, distribution techniques and marketing concepts (technical progress). In the long run, the actual goal of the entire production and competition process – which is to offer optimal service to the last link in the chain, i.e. the consumer – works better.

In reality, however, competition is frequently hampered by market barriers. Of special importance here are market entry barriers. Generally, these are factors that make market entry more difficult for newcomers or exclude them altogether, resulting in a lack of competitive pressure and the possible perpetuation of existing inefficiencies.

A distinction must be made here between structural and strategic barriers.

Examples of structural entry barriers are factors such as problems regarding the size of the business, product differentiation, absolute cost disadvantages, development costs, irreversibility or unfavourable times in the economy (when, for example, demand has

become stagnant). Key variables that can make market entry strategically more difficult are inflated capacities, price-cutting, product differentiation and vertical integration. All of these factors make the price competition more difficult for a newcomer.

But equally relevant for a healthy competitive market are market exit barriers. In stagnating or shrinking markets, which are characterised by the long-term decrease of demand, the economically necessary removal of excess capacities is delayed. This means that a brisk adjustment of the supply to declining demand is prevented. Imbalances of  $\rightarrow$ supply and demand remain. Resources remain tied up in areas where they are no longer required to supply the market.

An example of structural withdrawal barriers would be irreversible costs in the case of permanent, specialised production plants (sunk costs), contractual penalties when production is ceased without alternative sales opportunities, or the impossibility of modification of the plant for the production of other goods. Strategic exit barriers include concern for the corporate image, secondary opportunities to market the products or access to the financial markets.

Apart from market barriers that result from direct decisions by the economic agents, institutional market barriers must also be considered. These are based on national laws, public decisions or historical circumstances. Institutional market barriers of a structural kind related to market entry include the legislative organisation of commercial and corporate law and the patent and licensing system, as well as merger con-



trol; while in relation to market exit, social and political regulations such as government assistance schemes in the event of insolvencies (financial difficulties and bankruptcy) need to be mentioned.

Examples of strategically aligned institutional market barriers are regulations, merger prohibitions and trade barriers (market entry) as well as →*subsidies* or policies of moral persuasion and manipulation by trade unions, politicians and government institutions, such as in the case of threatened dismissals of workers (→*interest groups, lobbies*).

Contrary to the market barriers that are the consequences of the decision-making of private economic agents, institutional market barriers can be instrumental in the shaping of economic structure, and concomitantly that of the social market economy. Institutional market barriers can be imposed by the political decision-makers, e.g. for social and political reasons, and they can also be abolished again. The challenge is to determine whether in a certain area institutional market barriers are actually appropriate or not.

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Dieter Fritz-Abmus

## Parastatals

There seems to be little doubt that the production of marketable goods and services for private use or consumption – such as breakfast rolls and trips in a taxi – ought to belong to the area of competence of private →*enterprises*. The goods are called private goods because a market exists for them where the customers are prepared to pay at least a break-even price. This is the case because the buyers are able to enjoy the exclusive use or consumption by themselves (exclusion principle). But there is also a service sector offering goods which are useful to the public and from which the exclusion of others is not at all, or only partly, possible. This applies in cases such as national defence and street lighting.

The market fails to deal successfully with these public goods because the user or consumer is not voluntarily prepared to pay at least a break-even price for their use. It is true that such services are desirable to the citizens who consider them important. However, to motivate them to contribute to the costs of their production proves problematical.

People hardly see the need to pay a voluntary contribution for services if they can fairly assume that they are produced anyway and that they cannot be excluded from the benefit of their use or consumption. Therefore, the agreement on the type and extent of such primarily public expenses takes place in a political process outside the market, and the production is usually funded via the government budget in the form of taxation through compulsory contributions (→*tax policy, →public revenue*).

Apart from inherently public responsibilities, numerous specialised, defined tasks of public interest are permanently taken care of by independent institutions and budgets. They stand side by side with the budgets of the regional governmental authorities of the →*Federal Republic, federal states and municipalities*, and are therefore called parastatals.

Parastatals are quasi-governmental institutions (with financial autonomy and their own organisational structure and administration) which take care of community-related tasks. This puts them into a so-called third sector between regional governmental authorities – such as the representatives of territorial and social interests – and the market as the coordinating mechanism for private individual economic interests. Accordingly, parastatals are also called intermediate finance authorities.

Typical parastatals in the narrower sense of the word are the (mandatory) →*unemployment*, →*health*, →*nursing*, →*pension* and →*accident insurance* (social) schemes, as well as the professional representatives for commerce, the trades, industry and agriculture (professional parastatals). But the churches and other state-recognised religious communities also belong to this category. The funding for the services that these institutions offer is based on state-guaranteed entitlements, such as compulsory memberships (social security, →*chambers*) or additional tax procedures for the collection of contributions. This type of financial concession is usually justified by the outstanding social benefits (public interest) which result from the activities of such organisations.

In addition, some international

institutions can be identified as parastatals, such as development (aid) banks and possibly even the →*European Union*, since they carry out their government assignments autonomously and on the basis of their own financial resources and budgets. Besides these parastatals – more loosely defined – the so-called subsidiary parastatals and group parastatals also belong to this category. They differ from the abovementioned parastatals in the following ways:

- Social security parastatals are government institutions and serve the public interest. They have their own budgets and organisational autonomy, although they frequently receive funds from other public budgets (alimony). They are so-called special assets (e.g. the assets of the Federal Railway, →*Redemption Fund for Inherited Liabilities*, European Recovery Programme (ERP) special assets, the German Unity Fund, Equalisation of Burdens Fund) and government foundations (research foundations, cultural foundations). It is obvious, however, that in the →*public enterprises* (as previously in the case of the Post Office and the Railways) as well as the public institutions (e.g. the public broadcasting and television companies), the typical features of a subsidiary parastatal have become increasingly obsolete, particularly regarding government control of services and prices, as well as government funding. Services which used to be government funded are now treated as businesses which have to survive the →*competition*. In this way, the necessary foundation first for the legal and then gradually also the

material → *privatisation* of public enterprises (examples: German Telecom, the German Post Office, the German Railway) is being laid.

- Parastatals also include separate associations which primarily pursue group-related aims but whose services are equally highly beneficial to the public interest. Examples are charity groups, non-profit organisations and federations that partly offer marketable services (nursing, school education) and partly collective services (→ *interest groups*, *lobbies* such as trade unions, employers' associations and → *political parties*) which are useful to society, but also take on social tasks (e.g. care of the aged, social security assistance for the homeless). Such institutions are financially assisted through tax deductions and public subsidies.

Due to the great variety of these institutions and because of their differing institutional character, it is impossible to define parastatals with perfect accuracy. There is also a lack of easily accessible statistical data on many parastatals. This makes assessments and evaluations of government activities generally more difficult and also hampers international comparisons of the relevant expenditures.

The shift of government appointments to parastatal institutions consciously or unconsciously, reduces the transparency of their financial effects. But still more serious is the fact that democratic control over public functions, revenues and expenditures is diminished. In certain cases this can be of quite considerable macroeconomic

importance – such as when frequent shifts are made in the pension and health insurance sector, the enormous monetary currents of these funds and services are changed repeatedly.

In addition, such 'third sector' institutions can also be interpreted as a constant questioning of government competence: not only are they evading the general validity of the subsidiarity principle (→ *fiscal federalism*), they can in principle also be interpreted as a political challenge of the respective agencies to become more competitive. The dynamics of the political, legal, functional and economic processes make it advisable to carry out checks on specific assignments at regular intervals – if necessary followed by a restructuring of the institution in question – so that both the relevant business and public needs can be adequately fulfilled.

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## Patent system

The basic ideas on patenting developed during the age of industrialisation and when freedom of trade was first intro-

duced during the late 18th and early 19th centuries.

The core consideration in the course of the emergence of legal protection for commerce was to offer legally guaranteed protection from imitation or abuse (protective function) on the one hand, while creating incentives for technical developments and the emergence of new knowledge (information function) on the other. This means that by way of compensation, the inventor as the creator of new technology must be given the exclusive, albeit only temporary, right to use, manufacture commercially, offer and license the patented article. This ensures that the new knowledge is completely disclosed and made accessible to everybody.

At the same time, it is expected to become easily incorporated into the economically favourable process of research and development. A patent is therefore an exclusive but temporary monopoly which the inventor (or legal successors) is granted by the state. It permits the commercial use of the invention on condition that it be disclosed and that the technical innovation be made generally accessible.

In Germany, patents are distributed by the German Patent and Trade Mark Office, based in Munich. This is the supreme federal authority in its field and it reports to the Federal Justice Ministry. The European Patent Office, also in Munich, has been responsible for the distribution and administration of European patents since 1978.

Legal decisions in the sphere of patent law are based on laws and agreements: the first universal German Patent Act was created in 1877; the version which is valid today has been in

force since 1981. It particularly regulates the task of the patent office to examine, on request, the material patentability of a technical invention, to issue the patent in return for a fee (period of protection up to 20 years), and to publish the patent specifications with the accompanying disclosure of the innovations.

Only technical inventions that are genuinely new and commercially viable are considered patentable, such as a product, device, procedure, application or form of organisation. Not patentable, however, are discoveries, scientific theories and mathematical methods, 'aesthetic form creations', plans, rules or the reproduction of information.

According to German and European law at least, plant and animal species cannot be patented. Legally and ethically extremely controversial is the handling of genetically engineered animals, for which some countries (such as the United States) issue patents.

Patenting, albeit not in unrestricted form, is seen as an important prerequisite for the technical progress and economic success of a country. Since it has a protective function and because of the way it deals with information, patenting naturally stimulates innovation. It therefore also constitutes a significant element of the government's second-line technology policy.

It has been argued that patents make knowledge more transparent, promote creativity, prevent simultaneous and faulty developments, and reveal technical gaps to competitors, other industries and other countries. The temporary award of exclusive rights of disposal can be a strong incentive for individuals and

enterprises to focus on inventions and innovations which favour competition.

While these motivational effects have definitely been acknowledged from the point of view of innovation and technology policy, in the area of competition theory and policy it is particularly the restrictive effects which are being considered and investigated. And here it is not the delayed access to knowledge that attracts most of the criticism, but rather the delay in the process of dissemination within the sphere of innovation due to market entry barriers (→*open markets*).

It has been said that patenting knowingly hampers →*competition* and promotes monopolistic market structures by excluding potential competitors, especially small and medium-sized enterprises, from the new technology. There is also said to be the danger that by strategically patenting its own innovations and by buying up other patents, an enterprise may seek to dominate markets permanently. In such markets, technical progress tends to slow down and brings disadvantages for the economy.

It is up to the economic policy-makers to resolve clearly conflicting aims by paying proper attention to the underlying problems of patenting: on the one hand, the creation of new knowledge must be stimulated while at the same time illegitimate imitations must be prevented; on the other hand, it is their task to stimulate competition and the spread of the new knowledge by urging that new products and procedures should be copied.

The ideal form of patenting, therefore, has to offer sufficient incentives for innovative activities while also

allowing some scope for imitative uses of the patented technology in the interest of competition and technical development.

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### **Pension insurance (additional services)**

The 'additional services' of the pension insurance scheme are not by any means subordinate. Rather, they are the manner in which the compulsory pension insurance scheme is making key services which form part of the social security system, available to the public (→*old-age pension*).

In detail, the additional services of the compulsory pension insurance scheme represent interventions for the preservation and rehabilitation of earning capacity and pensions due to reduced earning capacity or surviving dependents' pensions.

Interventions for the preservation and rehabilitation of earning capacity (ss. 9-32 Social Legislation Code – VI) take preference over pension pay-outs.

Expressed differently, pensions are paid out only if effective rehabilitation is not possible at all or only at a later time. Rehabilitation services cover medical and employment interven-

tions. For this purpose, the agents of the pension insurance schemes have developed an extensive network of specialised institutions.

Apart from a threatened or impaired earning capacity, entitlement to rehabilitation services is conditional upon a minimum 15-year membership in the insurance scheme. While undergoing rehabilitation, the insured members receive bridging payments worth 80% of their last salaries.

Additional pension services (ss. 33-105 Social Legislation Code – VI), i.e. pensions which do not take the form of old-age pensions due to own contributions, can be based on a variety of different entitlements. Closest to the old-age pensions are the surviving dependents' pensions, which are paid out to surviving spouses and orphans. The crux in this case is that at the time of death, the deceased was entitled to a pension on which the claims of the dependants are based.

In contrast to this, pensions due to impaired earning capacity, or pensions which replace or supplement lost income, are paid out to the insured personally. Disability pensions that were conditional upon the ability to practise learned vocational skill were phased out by the 1999 Pension Reform Act. Especially affected by this are employees running a greater-than-normal risk to be incapacitated for work (e.g. bakers, nursing staff) and who would thus be forced to take out private insurance at contingency rates.

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## Policy consulting

The social market economy is not a clearly defined social utopia; rather, it is an open concept that can be adapted to changing conditions. This advantage, however, is also a danger: there is a risk that policy implementation is biased, sooner or later eroding the basic concept (→*social market economy: political implementation*).

There is a continual need to counterbalance conflicting basic principles. In terms of economic policy, the social market economy is an on-going task. This throws up the question: where should one turn for the sort of scientific policy consulting likely to make economic policy more rational?

In order to be able to answer this question one needs an understanding of what policy consulting is, an insight into the political process, and also a theory that clarifies the possibilities and limitations of steering politically an economy.

In all three of these areas a mechanistic, short-sighted approach must be avoided: policy recommendations do not follow scientific insights 'automatically'; policies cannot not be mechanically implemented, and economic cause-and-effect connections cannot be represented as a 'machine model' (→*market mechanism*).

### ***Possibilities and limitations of objective policy consulting***

If economics wants to get involved in policy consulting, it needs value judgments. Without value judgments, scientific theories cannot yield recommendations.

It is true that theories can explain how economic policy instruments affect specific objectives, but that does not mean that they automatically indicate which objectives should be pursued. The objective that scientific policy consulting ought to be 'value-free' refers only to the objectivity of the theories and not to the view that there ought to be no value judgments whatsoever.

But which value judgments should an economic consultant choose? An answer that is frequently given is the instrumentalist one. Here, the value judgment and political objectives come 'from outside' and science looks only for suitable (effective and economical) instruments.

At first sight this solution seems elegant, but it must not be overlooked that the 'mechanical' search for instruments in no way guarantees that the recommendations are value-free, because what is an objective and what is an instrument, is initially not absolutely obvious. This means that instruments also have a value of their own (objective-like) and that objectives can appear like instruments with regard to superior goals. But instruments can also have side effects on other objectives which are not being pursued (→*conflicting aims in economic policy*).

Without a value judgment it is impossible to decide which objective is more deserving (goal hierarchy) or

what the relationship between the intended final result and unintentional side effects on other objectives will be. Thus it is clear that scientific recommendations have to be based on a number of value judgments, even if the fundamental objectives come from outside. In either case, if policy consulting wants to be taken seriously it has to strive to disclose the value judgments which have been used.

On the one hand, the need for additional value judgments explains why economic policy recommendations by different experts can differ so greatly from each other. On the other hand, it means that science is by no means obliged to accept objectives 'from outside' as the final answer. It is also possible to reject an objective by referring to other value judgments.

In this context it is important to know exactly what 'from outside' is supposed to mean. Does an objective really reflect the ideas of all economic agents or is it derived from a political process in which individual interests are over-represented?

### ***Consulting for politicians and policy consulting***

The question where the value judgments and objectives of an economic policy can come from takes us to the target group of policy consulting. For the sake of correctness one ought to differentiate between policy consulting as a citizens' advisory service for all who are affected by economic policy, and policy consulting as consulting for politicians. This distinction is frequently blurred, and it tends to be considered sufficient to enlighten the political decision-makers.

This position tacitly assumes that politicians act exclusively in the interest of their citizens. A politician is therefore imagined as a 'benevolent dictator' who mechanically converts the well-meant advice received from the policy adviser into good policies, and who has the necessary power to do so. But to consider the political process simply as 'policy mechanism' would be wrong.

Fortunately, in a democracy, politicians are not dictators, which also means that in the process of implementing recommendations they are bound to meet with resistance. Even if an economic policy measure has benefits for all, →*interest groups* who see themselves on the losing side can undermine its implementation.

Politicians are also not completely deaf to the promotion of individual interests. This is because, in the short term, the political support of well-organised interest groups is often more important to politicians than the satisfaction of the disorganised general public and their interests. This shows that the intentions of politicians, too, are not endlessly benevolent or exclusively aimed at the common good. This self-interest of politicians has been given special emphasis in economic policy theory (public choice).

However, this way of thinking would be accompanied by another mechanistic error: the assumption that politicians are strictly self-interested, combined with political competition modelled as a market mechanism, results in political acting being absolutely determined. The policies are completely governed by politicians' interests and by political opposition.

If, however, policies are determined

in such a manner, then any attempt to change them by gathering information on better policies is senseless: advising politicians is impossible (the determinacy paradox).

An argument against this is the empirical observation that there have indeed been comprehensive economic policy reforms that were implemented on the recommendation of scientific advisers.

In theory, the bulk of information that is assumed in the model speaks against the impossibility of advising politicians. In the long run, the politician must be just as well informed as the benevolent dictator in the model. The information required concerns the effect of political measures, political opposition and – which is not natural by any means – personal interests. The model also assumes that these self-interests are permanent and stable. There is thus no chance that intentions change and that, for example, the opportunist turns into a statesman or a passionate reformer.

Political opposition is likewise assumed to be stable due to the fact that policy consulting is exclusively understood as advising politicians. If advising citizens comes into the picture, these boundaries may change.

In conclusion, it can be said that advising politicians may be possible, but that it is not enough. Policy consulting – in the form of advice for citizens – is an important project for scientists. Only in this way can political opposition to a rational economic policy – which the model of the benevolent dictator overlooks but which is a permanent feature in the pessimistic model of advising politicians – be reduced.



### ***Possibilities and limitations of political control***

Many of the mistakes described so far are based on the mechanistic misinterpretation of the economy. When recommendations are value-free, one of the problems is how to balance the intended effects against the unintentional side-effects. The necessary evaluation of the side-effects is left out of the picture precisely when total controllability of the economy is assumed. Side-effects are then faded out. In terms of advising politicians, it is clear, for example, that the benevolent dictator also has to assume controllability of the economic process. Only under this assumption are the 'well meant' economic policies successful in practice or 'well done'.

In each case, the underlying concept of economic cause-and-effect interdependence is a 'machine model'. If the mode of operation of the 'economic machine' is known, one automatically has the necessary information on how to manipulate the different settings of the economic policy.

A fundamental objection to this view is the fact that the different elements of an economic system are simply not the cogs of a machine which run evenly and smoothly all the time, but flexible and creative actors who can evade political control. This means that the same political intervention can have quite different effects.

If, however, the effect cannot be stated with complete certainty and precision but only an approximate range of possible effects is known, then the attempt at control must be scaled down. This is precisely associated with the priority accorded to →*institutional order pol-*

*icy* within the concept of the social market economy.

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### **Political parties**

In a pluralist society there are a large number of groups, institutions and →*interest groups* putting pressure on the government's economic policy. The political parties play a particularly important role in this. Modern democracies are therefore also referred to as 'party states'.

Parties are organised associations of persons who have the same political, social, economic and philosophical outlook and who want to influence the political process. They are even constitutionally acknowledged in the Basic Law of the Federal Republic of Germany (Article 21).

Political parties are supposed to participate 'in the formation of the political will of the people', and they have been assigned the 'rank of a constitutional

institution' (Federal Constitutional Court 2.1/73). A pluralist society needs a pluralist party system that takes political →*competition* between the parties for granted.

Lastly, parties want to win a parliamentary majority in order to be able to exercise their political power. They defend their goals in parliament and in other public bodies in order to have the opportunity to see their ideas practically implemented when they represent the government, or at least a part of it.

The government can crucially influence economic policy through laws, regulations and programmes and by exerting direct pressure on other actors. It can make a decisive contribution to the preservation of existing liberties and the unlocking of potential liberties, which a successful economy needs.

At the same time, the government and the parties behind it influence the administration, the official media and the public sector of the economy through a well-conceived human resources policy.

The minority parties represent the parliamentary opposition. They generally cannot do much more than monitor and criticise government activities. Regarding economic policy, however, minority parties play an exceptionally important role because economic processes affect every single person so profoundly. Moreover, economic policy frequently has conflicting aims. A goal – such as the reduction of →*unemployment* – can be opposed to another – e.g. the protection of →*price level stability*.

And lastly, political and economic policy is nearly always connected with the redistribution of funds, legal positions and status. Above all, it is the task

of the opposition to point out these conflicting aims in political and economic policy, to clarify situations and to criticise government positions that are harmful to the common good (→*conflicting aims in economic policy*).

Political parties do not operate only through parliament. What they can achieve before and outside parliamentary sessions is of equal importance. There, they offer citizens the opportunity of participation in the formation of their political will.

'They unite voters into political action groups and thus become the mouthpiece of people who have come of age and who want to be heard ... Without their mediating role, the people today ... would not be able to exert any influence on the political process and thus to express themselves in the political arena.' (Hesselberger, p. 176). Political parties are often anxious to influence public opinion, win new supporters, mobilise their constituencies and represent and reinforce their position through suitable candidates in election campaigns.

Parties are therefore not only supposed to organise but also to comprehensively interpret reality. It is true that outsiders are continually trying to manipulate political parties and that they do, indeed, represent individual interests. However, in order to organise society as a whole, to represent individual interests will not suffice. It also does not suffice to win a majority among the people and in parliament. This is why political parties have to work out comprehensive concepts for society and the economy with the common good in mind, and in addition to develop instruments with which to turn these

social programmes into reality. This is the fundamental difference between political parties and trade associations, →enterprises or trade unions.

In the course of the competitive process between the parties, many different programmes have been and are being presented. In today's party spectrum they are mainly liberal, socialist and conservative. However, the manifesto of a party is not only laid down in the programme of a party but also in its actions and direct statements.

The history of the Federal Republic of Germany shows that in terms of the parties' economic policy concepts, a convergence has taken place between them. The conceptual differences (polarisation) between the parties have decreased over the years, thus making the formation of coalitions easier today. With the exception of the Party of Democratic Socialism (PDS) – now part of The Left. party – all the parties represented in the *Bundestag* (parliament) today subscribe to the concept of a market economy.

When after the Second World War the Christian Democratic Union (CDU) initially presented an economic concept containing various socialist elements (the Ahlen Programme, 1947), it did not take long before the concept of the social market economy became generally accepted under the influence of Ludwig →Erhard (the Düsseldorf Principles, 1949).

With the unparalleled success of his economic policy, the Free Democratic Party (FDP) soon followed suit. In reaction to its parliamentary election defeats during the 1950s and 1960s, the Social Democratic Party (SPD) aligned itself to the successful concept of the

CDU, but without ever officially adopting the term →social market economy. In 1959 it agreed on the Godesberg programme, which represents a break with socialist economic concepts. Even the *Bündnis 90/Die Grünen* (Alliance '90/The Greens) is showing signs of wanting to follow the example of the social market economy. These examples show that the economic policy concepts of the parties can, and actually have to, change as they are searching for answers to economic and political challenges.

The convergence of the economic policy programmes does not mean that all parties represent and promote the same economic policy. It means, rather, that a number of different economic policy concepts – such as political programmes – are based on demand or supply orientation, or on →monetarism. Also, there are very different concepts of the role of the government in the economy, the extent of the necessary bureaucracy and its costs, the significance of large corporations and the middle classes for the economy and society, over the extent of the development of the →social/welfare state. In the detailed answers to these questions and the way they are put into practice through political processes, the convergence of economic policy concepts soon comes to a halt.

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## Poverty

### *Origins of evaluation*

Poverty is a constant component of the history of mankind. There is an unequal distribution of goods, money, rights, talents, knowledge, etc. in every society. If this inequality leads to a crisis situation, which is not limited in duration, it becomes rather the determining situation of the persons concerned – and then one speaks of poverty.

The evaluation of poverty has never been clear in European culture. On the one hand, the old tradition of stigmatisation where the poor are condemned continues; on the other hand, the New Testament's demand to care for the poor (*caritas*) is viewed as a Christian virtue, with some freely choosing poverty as a way of life (mendicant monastic order).

Taking care of the poor was traditionally a task of the church, which was increasingly undertaken by the poor-houses and charities, thus making the transition to the jurisdiction of the municipalities.

With the beginning of industrialisation, poverty was viewed less as an individual fate and more as a consequence of economic and social processes. Thus, towards the end of the 19th century, public facilities took over the responsibility – 'social security' – to secure and reduce poverty risks (illness, accident, unemployment). Today's struggle with poverty is justified along the lines that it is an attack on human dignity, a handicap to self-development possibilities of those concerned, and has economic and political consequences, such as criminality, migration and unemployed growth reserves.

### *Types of poverty*

The modern scientific and political discussion on poverty focuses on the situation in many developing countries and the lack of necessary food in those countries. In part, the physical subsistence level and the survival of humans are not secured. This level of absolute poverty is attained, according to the definition of the World Bank, if those concerned have less than a dollar a day to live on. This kind of evaluation is relatively easy to apply, statistically speaking, if income data are to some extent available for the country concerned.

The poverty discussion in industrialised countries – in the former communist countries as well as the emerging markets – is, however, quite different. It concerns much more than the material survival of the poor; more accurately, it concerns the capability of the poor to share in a general social life – or the exclusion from it. Thus, poverty is much more than differing degrees of material equipment, resources and means of subsistence. Beyond this, there are models that cite the lack of social contact, human affection, education, dependence, etc. as poverty. The term poverty must therefore become applicable to more complex situations; accordingly, it is that much more difficult to measure.

The Council of Ministers of the →*European Union* tried to elucidate a definition of relative poverty, a definition according to which Germany also orients itself.

The minimum, therefore, refers to individuals, families or groups of persons who have so little (material, cultural and social) means that they are excluded from the way of life consid-

ered a minimum standard in the member state in which they live.

This complex understanding of poverty orients itself along traditional conceptions. In the Middle Ages, the beggars and those without taxable wealth were not the only persons to be considered poor. The term 'poor' also applied to persons who, unlike the 'strong ones', had neither physical strength nor social power, who were disadvantaged in legal respects and who were unable to defend themselves with a weapon. This definition applied to older, sick or disabled persons, widows, orphans and prisoners, as well foreigners and pilgrims.

### *The problem of measurement*

In science, there are several ways of measuring poverty, whereby the standard operationalisations derive data from the earned market income. Thus, they focus purely on economic categories (income poverty). This is correct: everyone must have a minimum income in order to live a life in dignity and to participate in social life. The question concerns itself with the resources necessary to live.

Deviation from the average income is frequently used as the most important measurement tool for poverty in connection with EU poverty programmes. According to this approach, those earning less than 50% of the average income of a national economy to cover living costs are considered to be poor. Other limitations are conceivable and are being used. According to Germany's first 2000 Poverty and Wealth Report, between 5.7% and 19.6% of the German population are to be identified as poor.

This concept has met with diverse criticism – criticism applicable to comparable poverty evaluations. A certain amount of resources available to an individual do not stem from the market: self-work, do it yourself, domestic economic activities, hypothetical rent for self-occupied lodging, income from illegal employment, smuggling, etc. These resources are not classifiable as market income.

Furthermore, state transfers must be understood as a resource supply not occurring through the market. These include free education, subsidies for public libraries, swimming pools and transport, rentals, nationally promoted social services, crèches, etc. It is estimated that the monetary value of these state benefits amount to approximately a quarter of the official available average German income.

This concept, therefore, does not measure poverty; rather, it measures imbalances among the distribution of income. One could, according to this method, conclude that poverty is less predominant in North Korea or Cuba than it is in Germany, even though some people in those countries are starving. The relative uniform distribution of all  $\rightarrow$ incomes is the cause of this. The temporal comparison of this measurement method is also problematical because the same proportional increase of all incomes does not change anything in the degree of the poverty. Thus, by definition, poverty cannot be overcome as long as humans earn different incomes.

It is paradoxical that when one takes away from the rich, poverty decreases – without having given anything to the poor. The average is reduced, the

poverty line is lowered, and thus poverty is reduced.

A further criticism concerns the economic and sociological reasons behind this measurement. There is no scientific reason to use the average income of a population as a reference variable for comparisons. A further question addresses the concrete population of comparison. Strictly speaking, the comparisons should be made only in a social context. Likewise, it cannot be substantiated why those who earn less than 50% of the average income are considered poor.

Furthermore, the computation of the statistical variables reveals the problem that the households receiving income are of different sizes. The conception prevails that with each further household member with the same lifestyle, a smaller income is needed because different goods are used jointly. In order to generate comparability in this case, the income amounts are translated into equivalent incomes. Depending on how these are applied, the magnitude of 'measurable' poverty can be manipulated.

As a further important indicator of poverty, social welfare assistance (→*basic social security*) is considered. Assistance is granted when personal financial means and other social security measures have run out. Germans and foreign nationals receive social assistance if they meet the criteria.

The minimum subsistence level is to be guaranteed through social assistance, in order to give the recipient the opportunity to live with dignity. Exercising the option to claim social assistance, however, leads to the impossibility that poverty can occur – eco-

nomically speaking. Otherwise, the level of social welfare assistance and the subsistence level would be wrongly established. Social welfare assistance can therefore not be an indicator for poverty; rather, it measures that poverty which is prevented through assistance.

Furthermore, social welfare assistance as a criterion for poverty leads to results that do not correspond to its objectives: therefore, countries with an extensive social assistance system have many poor, while countries without a social security system have no poor. Following this train of thought, since the expansion of aid and the increase in those able to apply would increase poverty, the most effective way to battle poverty would thus be to reduce or abolish the social assistance system!

Social welfare assistance statistics are also less suitable as a means to measure poverty because they evade economic-political and socio-political influence. Take, for example, immigration to Germany. This segment of social assistance has taken on such a dimension that it determines levels and directions. However, this means that increasing numbers of recipients of social assistance do not equal the pauperisation of the population in our country. Rather, the German concern for immigrants is being expressed.

There is a group of people who live on less than the subsistence level in accordance with the social welfare assistance and who do not exhaust their entitlements as outlined in the social welfare assistance system. One can only speculate as to the reasons for this 'hidden poverty': shame, ignorance, embarrassment at asserting entitlements concerning their families, embarrassment

at the examination of their personal situation, e.g. because of net assets or waiting for social security entitlements or other services.

The term 'hidden poverty' is misleading because, according to the definition of social assistance, this circle of people is actually the poor: the income of these persons lies below the minimum subsistence level. However, there are only a few empirical investigations on this subject.

### **Several conclusions**

The strong relativisation of the term poverty that exists in current poverty research, positions the idea of poverty closer to the general concept of social failing and inequality of lifestyles. All personal problems become social problems and thus become the substance of →social policy, in particular poverty problems. Poverty is not the opposite of luck and does not refer to how income is utilised by the individual. Poverty is not inequality. 'Participation' refers to the things required in order to function as a social being and, as such, is an objective fact.

Repositioning social policy to focus on the problems of poverty and exclusion-related policy would alter the significance of social policy.

To date, social policy presents itself as a relevant, society-structuring and fundamental regulation, supplementing policy that is relevant for all citizens.

A society that lives in immeasurable wealth – compared with earlier times and the rest of the world – obviously needs a certain degree of conscience in order to be able to deal with this affluence. Many humans are also conscious that the affluence is constantly endan-

gered. The public, therefore, is sensitised towards the subject of poverty and thus ready to believe that poverty in our society constantly rises. Phrases such as 'dismantling the welfare state', 'new poverty', 'two-thirds society', and 'exclusion' are falling on fertile soil. Some scientists, journalists, politicians and also church representatives operate their 'business' with this subject. This emotion-packed subject is suited more than any other to convincingly assigning political guilt. This happens not only in regards to certain persons or parties, but also in regards to the current economic system in Germany. At the same time, however, it would seem that the real poor in our society, the vagrants, homeless, etc., receive scant attention.

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Horst-Dieter Westerhoff

### **Price level stability**

If in connection with economic policy objectives – as, for instance, in the case of the European Central Bank – one comes across the term 'price stability', what is actually meant is the 'stability of the price level', as it is more accurately called, for example, in the German

Stability and Growth Act of 1967. The point here is not a lack of flexibility or reactivity of the prices of some goods, but rather the prevention of blanket price level increases. The aim is therefore to keep the total value of a shopping basket constant, as opposed to each individual unit price of the numerous goods and services contained in this basket. Precisely because over time some prices rise, others fall and a third group remains constant, is an expression of the free play of market forces – but the sum total of all these changes have to add up to a stable price level. This is also frequently referred to as currency stability.

The particular importance attached to this issue, especially in Germany, is a consequence of historical events. As a result of two periods of severe inflation after the First and Second World Wars with their subsequent currency reforms, particularly the older generation has become hypersensitive to inflation. Against this background, for Walter →*Eucken* a monetary policy that focused on currency stability was among the key features of the competitive and social system – which he and his ordo-liberal Freiburg Circle devised.

Actually, a stable currency is assigned top priority: ‘Any effort to implement a competitive system is bound to fail, as long as a degree of stability of the monetary value has not been secured. In a competitive system, therefore, monetary policy is of the highest importance.’ (Eucken, 1955, p. 256). But for Ludwig →*Erhard*, too, it was obvious that ‘... without a consistent price stability policy, the social market economy [is] not conceivable’

(Erhard, 1964, p.15). In his inaugural speech on 18 October 1963 Erhard said: ‘Efforts to achieve a stable price level are at the top of the economic agenda.’

From today’s vantage point, the (economic) damage which inflation inflicts has been extensively debated both in the light of contemporary theory and empirical observation, and makes the above statements particularly credible. It follows that inflation has a negative effect not only on →*growth* and →*employment*, but also on the distribution of →*income* and capital. In a →*market economy*, the (relative) prices assume a controlling and warning function.

If inflation kicks in, it is harder for →*entrepreneurs* to see clearly which goods are really in short supply and where new investments are required. Rather, inflation paints a picture of shortages and the factors of production labour and capital are channelled into the wrong places. In the long run, the allocation function of prices is disturbed and growth slows down.

The popular opinion that inflation favours employment and growth applies only in the short term, if at all. The apparent choice one had before the theoretical background of the Phillips Curve, culminated in the statement of former Federal Chancellor Helmut Schmidt that one should accept ‘rather 5 per cent inflation than 5 per cent unemployment’.

In the medium- and long-term, however, a positive employment trend cannot be bought by inflation. The workers cannot be deceived for very long and will (in line with the anticipated inflation) demand higher wages, wiping out the short-lived employment stimulating effects of inflation.



More recent empirical investigations even come up with the result that the negative growth effects described above tend to drive up → *unemployment*, which would be reflected in a positively inclined Phillips Curve (→ *conflicting aims in economic policy*).

Taking this one step further, if one considers an open national economy with a system of fixed exchange rates relative to its trading partners, under these circumstances (higher domestic) inflation weakens the international competitive ability of the domestic suppliers. The country's exports will fall, while imports will go up. The associated decrease in demand has a further negative effect on the domestic job market.

Furthermore, inflation can be associated with a number of adverse redistribution effects. On the one hand, the theory refers to the so-called wage-lag and the transfer-lag hypothesis. If the wage income of the employed, or government transfer services such as pensions, social security assistance, rent subsidies or child benefits go up more slowly than the price level, the result is a deterioration of the material position of these groups of people.

The creditor-debtor hypothesis, on the other hand, in the context of the theory of property distribution, assumes that inflation turns creditors into losers, because nominally fixed claims lose value, while debtors gain from inflation.

This is also the reason why the state – having become a debtor over the past several decades in Germany – is believed to be very keen on inflation. At the European level, the fiscal criteria of the Treaty of Maastricht are applied in

an attempt to curb this interest in inflation.

Thirdly, financial assets and material property are often differently affected by inflation. The danger of material loss of financial capital in times of monetary depreciation therefore frequently leads to an 'escape into material values' (concrete gold), which are most likely to provide protection from inflation. Inflation is therefore a hindrance to savings, and through allocation distortions (mismanagement) leads to a macroeconomic shortage of productive capital.

Finally, there are adverse inflation effects which can result from the taxation system. If, for example, higher incomes fall into a higher tax category (progression), inflation results in income redistribution in favour of the state and to the detriment of the economic agents. This, too, can have a negative impact on growth.

From the point of view of distribution, therefore, inflation comes across as extremely antisocial, making a consistent economic policy focused on stability the most desirable → *social policy*. Price level stability plays a particularly important role at a time when – as now – the issue under discussion is a limitation of claims from government and social security services, and instead putting more emphasis on private initiative and responsibility. People can make their own provision for old age and bad times only if they can rely on a stable currency.

As initially indicated, price level stability exists, strictly speaking, only when the inflation rate is zero per cent. It follows that the efforts to make price level stability qualitatively operational (useful in practice), have to focus on the

search for a standard by which inflation can be measured. Of relevance here is how to define a shopping basket (bundle of goods) and how to measure its price increase.

Depending on the content of this shopping basket, one differentiates between indices which are not all equally clearly defined. Examples include the deflator of the gross domestic product, the cost-of-living index of private households and the import and the export price index. Since the consumer (and voter) is primarily interested in the price trend of the goods which are typically bought, the cost-of-living index of private households is of extreme importance in measuring inflation.

In the context of the European Monetary Union, price level stability in the euro-zone is monitored with the help of the consumer price index (CPI-EU), which is itself calculated as the weighted average of the harmonised consumer price indices of the member states. In this context, the 'harmonisation' primarily refers to procedures and methods of computation and not so much to the consumer habits of a particular country.

The European Central Bank made its primary objective – price stability – quantitatively operational (*modus operandi*) with an inflation rate (CPI-EU) of less than 2%. This limit can mainly be explained by procedural (measuring) problems. If, for example, consumer habits change without the shopping basket being (immediately) adjusted, the price index is no longer up to date and meaningful. A further problem results from quality variations. If the quality of a product improves and

its price goes up simultaneously and proportionally, there is no inflation. But these effects can be sufficiently taken into account only in exceptional cases, meaning that inflation may be over-represented.

Particularly in view of the costs of inflation detailed above, it has to be welcomed that in recent years – at an international level as well – there has been a growing consensus about the need to make the protection of price level stability the key task of financial and monetary policy.

Empirical studies have shown that issuing banks which are not subject to policy directives are more likely to maintain currency stability. Autonomous issuing banks therefore have lower average inflation rates than dependent ones, without having to 'pay' for this with lower growth rates. The success of the →*German Federal Bank* in achieving stability is thus not historically unique or exceptional. On the other hand, the independence of the issuing bank is only a necessary condition for price level stability; it can definitely not be interpreted as a sufficient condition to guarantee success.

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## Privatisation

The spectrum of tasks taken on by the state is not unalterable. Instead, new areas of activity are added over time (the expansion of state involvement), while other tasks can be considered as settled or else they can be handed over to the market. In the case of the post office and telecommunications in Germany, for example, the transfer of services which had previously been part of the government budget or →*public enterprises* to private actors, leads to more prosperity for society as a whole. The process of transferring services from government control to the private sector is called privatisation (decrease of state involvement; another example is →*deregulation*).

A variety of reasons can be behind such externalisation processes. In the first place, public enterprises were established by government in the past for the purpose of generating additional revenues. However, it is a fact that the profitability of public enterprises tends to be below average. Due to their privileged position, such institutions do not have to contend with competitive pressure, nor do they have to show the flexibility or customer-orientation of private enterprises. This is why privatisation is generally expected to bring about lasting efficiency gains.

Second, as a consequence of technical progress it is now no longer correct to refer to certain services as 'public goods', nor can 'natural (state) monopolies' still be justified. Thanks to savings in the sector of satellite television, for example, the profit opportunities of channels funded through advertising have grown so much that private enter-

prise is now able to enter into competition with public broadcasters.

Third, it must be stressed that the concept of 'public good' depends on whether the individual or group of people looking at it at any one time feel that a certain service has more the character of a public good or a private good. It is therefore a contentious issue whether banking services through local savings banks ought to remain available in future or whether an appropriate service by private financial institutions can be regarded as sufficient. Accordingly, the general policy programmes of the different political parties also disagree on which services ought to (still) be the responsibility of government authorities. This state of affairs may provoke significant privatisation projects after the most recent change of government (→*parastatals*).

The private sector is keen on taking over such services if they yield additional income and capital. These result on the one hand – provided the services are continued – from the efficiency gains described above, or, on the other hand, the factors of production connected with the transfer (the privatisation) can now be put to more profitable use. The dedication of former military areas to civilian causes (conversion) is just one example.

Depending on the individual case, the most suitable of many different strategies can be utilised to carry out the privatisation. Most transfers take place in return for a payment, which is then entered into the government budget as once-off revenue (→*public revenue*). If it has sufficient marketability, it is often best to put the relevant assets up for auction in order to determine the sell-

ing price. This is the best way of finding out whether any demand for such properties exists.

In terms of the effects connected with privatisation, the following three outcomes are possible:

- The government institution available for privatisation may have been operating at a loss, and this remains the case even after the transfer into the private sector. In such a case it would initially be hard to find a private buyer. If, however, public interests stand in the way of a definitive transfer, it might still be expedient from the government's point of view to minimise the running losses by privatising. This can be done by 'sweetening' the sales offer by means of a certain subsidy (→*subsidies*). The government has to consider this option if the subsidy is smaller than the losses incurred should the institution remain under state control in the long term.
- It is possible that due to the efficiency gains that have been described, or as a result of restructuring measures implemented by the private sector, a loss-making concern can be developed into a profitable business.
- By being privatised, government enterprises that are already making a profit can improve their profits.

It follows that in the latter two cases, all-out privatisation is worthwhile. This notwithstanding, it is assumed that consumers can go on expecting to receive the same quantity and quality of goods. If not, adequate private economic task fulfilment has to be supervised and

controlled. That would make further governmental regulation procedures necessary, the effects of which have to be compared with the degree of privatisation that has been reached (example: the establishment of the regulatory authority for the telecommunications sector).

Thus, on the one hand, successful privatisation – thanks to the proceeds gained and future expenditure on running concerns saved – opens up the possibility of reducing government involvement. These budgetary savings could then be passed on to the private sector in the form of tax cuts. The state gets 'slimmer', which is reflected in a lower government ratio (proportion of public expenditure in the gross domestic product). The state becomes more transparent and the government budget less risky.

Under the right conditions, therefore, the capital market will be prepared to reward this by offering more advantageous ways of financing the national debt. Alternatively, the additional funds that have been freed in this way could be used by the state to finance other activities. In this scenario, only the structure of the budget would change while the government ratio would remain the same.

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## Production and supply

A national economy has to be productive in order to be able to satisfy its need for goods that are in short supply. This production of goods includes every sector of the economy, from the production of raw materials (e.g. the mining industry) to the processing and manufacture of goods (e.g. the automobile industry), all the way to the distribution of goods (e.g. through transport and trade). In order for the goods to be able to be manufactured (as output), certain means have to be used (as input). These means are the factors of production.

There are three different groups of factors of production: labour, land and capital. Labour is defined as every kind of human activity which is performed for the purpose of satisfying the needs of others and which at the same time serves the purpose of  $\rightarrow$ income acquisition. The activities of both the employees and the entrepreneur are classified as labour (work).

Land is the generic term for all the resources which nature makes available (natural resources). Included in this is the land on which industrial plants have been erected and land which is used for agriculture and forestry. In addition, all mineral resources, stretches of water and vegetation belong to the factor land.

The factor of production capital comprises all goods which have been produced in the past – but which have not yet been utilised – and with which  $\rightarrow$ enterprises can manufacture future consumer goods. These include factory buildings, machines and tools. Besides that, the existing stock of manufactured goods is ranked as capital too. Money (or financial capital) does not, however,

belong to the factor of production capital.

Capital as a factor of production is always ‘material capital’. The accumulation of material capital serves the purpose of increasing future goods production. The amount of available capital depends on the extent to which one has initially abstained from consumption – how much has been saved – in order to buy factors of production with the available financial capital and to develop material capital, such as in the form of factories. It must also be remembered that in the production process, a part of the material capital is continually worn down (depreciation) so that it has to be replaced again and again.

Not only the quantity of capital is important, but also its quality. Here, the positive effect of technical progress becomes obvious in the sense that it improves the quality of the factor capital. This means that over time, thanks to technical progress, with the same quantity of capital (as input), a higher productive yield (as output) can be achieved.

The production of goods is a process in which the three factors of production are combined. To do this successfully, technical and organisational expertise is required. This consists in knowing about the best methods of production and organisation. Excellent technical and organisational know-how is beneficial for the production process. It is also beneficial if previous knowledge as well as new scientific discoveries can be put to use rapidly and purposefully (the contribution of information to the production process).

The macroeconomic production curve describes the relationship between the employment of the factors

of production (as input) and the level of goods production (as output). This makes it possible to calculate the productivity of a national economy as the quotient of the goods output obtained (in the numerator) and the required input (in the denominator). This total productivity can then be used to work out the partial productivities for the individual factors. The work productivity, for example, is the relationship between goods production and employment of labour.

Division of labour usually has a positive effect on productivity. This is defined as the specialisation of the factors of production on certain activities and categories of goods. It means that workers and enterprises do not have to manufacture all the products they need themselves, but that they can concentrate on those areas of work and production in which they are particularly efficient.

How satisfactory the supply of the individual factors of production is in a national economy depends on a large number of factors. Land is by nature limited and can, for example, as a by-product of the production of raw materials as well as a location, be expanded only to a small extent. The total labour supply of an economy is determined by the total number of people employed and their working hours, while the individual worker, when looking for a job, will try among other things to obtain the best possible wages. Material capital is either produced by the enterprises themselves or it is acquired by specialised capital goods producers – i.e. by other enterprises.

In order to be able to create (i.e. to invest) capital goods, the enterprises

have to use financial capital. Since this means that if they have to take out loans (or abstain from personal money investments) they will be charged interest, the formation of material capital depends on the respective level of interest and the readiness of households to save.

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*Hans Peter Seitel*

## Profit

The term 'profit', which in everyday usage is a synonym for 'benefit', 'money-making', etc., has no clear definition in business administration. Rather, there is a set of terms denoting profit as a function of the specific purpose underlying the determination of profit. Examples of such purposes are:

- as a way of measuring income;
- as a creditor's protection;
- as a way of conveying information;
- as a basis for taxation assessments; and
- as an evaluation of shareholdings.

The →*enterprise* uses its cost accounting to calculate the profit and to assess whether the sale of its products or services at their respective prices was successful. The profit on the balance

sheet normally forms the basis for the variable remuneration of managers, the distribution of dividends to the company's shareholders and the amount of taxes paid to the national treasury.

Moreover, the company profits serve as information for shareholders and interested members of the public regarding the financial state of an enterprise. Trade union representatives frequently pitch their wage demands against the profit situation of a company; it helps workers to assess their job security and banks take a company's profits into account when taking decisions about credit allocations.

However, there are different ways of calculating profit. While most companies in Germany calculate their profits in accordance with the Code of Commercial Law, many of the large enterprises quoted on the stock exchange have been drawing up their balance sheets based on either international accounting standards (International Financial Reporting Standards, IFRS) or on United States (US) accounting standards (US-Generally Accepted Accounting Principles, US-GAAP).

From 2005 onwards, the majority of European companies quoted on the stock exchange will be forced to draw up their balance sheets in keeping with the IFRS. Single annual accounts are exempt from this rule, but they must still follow the regulations of the Code of Commercial Law.

Lastly, when profits are calculated for fiscal purposes, certain prescriptions which differ from the Code of Commercial Law have to be observed, which shows that there are numerous different parameters to measure profit.

The opposite of profit is loss. In principle, any (positive) balance of basic figures in the field of business accountancy, i.e. deposits/disbursements, income/expenditure, returns/expenses, proceeds/costs potentially represent profit (→*business accountancy: basic concepts*).

In external accounting, profit is understood as the surplus of revenue after expenditure. Apart from the balance sheet, which is supposed to be a reflection of company assets, every business person is also obliged to draw up an annual report in compliance with the commercial law and which includes a profit and loss account, detailing his/her sources of profit. In contrast to the balance sheet, which is an inventory calculation at a specific point in time (customary date: the last day of each year), the profit and loss account represents a flow-aggregate calculation for a certain period of time (listing of all revenues and expenditures for the calendar year).

The detailed form of the profit and loss account is legally regulated only for corporations (e.g. limited liability company – Ltd; public limited company – plc). Private firms and unincorporated firms (e.g. limited and general partnerships) merely have to observe the general principles of transparency and completeness.

In practice, many →*enterprises* in Germany use the legal regulations for corporations. The profit and loss account is supposed to show whether and to what extent the main objective of private enterprise – profit – has been achieved. The literature on economic management propounds the view that the ultimate aim of doing business in a

free market system lies in the maximisation of profits. At the same time, however, reference is made to the fact that the principle of profit maximisation is not to be pursued in isolation but under the observation of secondary conditions, such as customer satisfaction, social responsibility towards the workforce, compliance with environmental regulations, etc.

Profit and loss calculations are helpful in making it absolutely clear that there is no such thing as 'true' profit. In order, for example, to gain an indication of the profitability of an enterprise regardless of its current levels of taxation, it may make sense to focus one's attention on the annual surplus before taxes.

For a more exact picture of the success of the actual business activities of an enterprise, the operating result tends in fact to be used more frequently. The operating result is calculated by deducting all the amounts which are not business related, extraordinary (e.g. pro-

ceeds from the sale of substantial shareholdings), not regularly arising, a-periodic (e.g. late payments of public charges) and outside the actual purpose of the business (e.g. donations to charitable organisations) from the annual surplus. The operational result (earnings before interest and taxes – EBIT) is frequently used as a profit calculation before interest and taxes.

For the comparison of enterprises, the earnings before interest and taxes, depreciation and amortisation ratio (EBITDA) is frequently used.

Aside from the profit concepts in commercial law and in the cost and results accounting, theoretical concepts of profit are also under discussion. In terms of the theory of economic profit, profit is recognised only if the so-called capitalised earnings value of the enterprise at the end of the financial year exceeds that at the beginning of the financial year, provided that there has not been a payment of dividend. The capitalised earnings value of an enter-

#### Income statement of Volkswagen AG, 2005 and 2006

in € million

	<b>2006</b>	<b>2005</b>
Sales revenue	53,036	50,245
Sales expenditures	54,238	50,225
<b>Gross profit on sales</b>	<b>-1,202</b>	<b>+20</b>
Selling expenses	3,377	3,086
General and administrative expenses	602	505
Other operating income	2,844	2,556
Other operating expenses	1,669	1,683
Financial result	+5,216	+4,136
Write-downs of financial assets	1,165	497
<b>Result from ordinary activities</b>	<b>+45</b>	<b>+941</b>
Taxes on income	-900	200
<b>Net income for the year</b>	<b>945</b>	<b>741</b>

Source: Volkswagen AG



Balance sheet of Volkswagen AG as at 31 December 2006					
in € million					
Assets	31.12.2006	31.12.2005	Equity and Liabilities	31.12.2006	31.12.2005
Fixed assets	23,583	21,351	Equity	10,254	10,976
Current assets	21,997	22,303	Special tax-allowable reserves	81	88
Prepaid expenses	22	9	Provisions	18,849	16,858
			Liabilities	16,418	15,741
<b>Total equity</b>	<b>45,602</b>	<b>43,663</b>	<b>Total liabilities</b>	<b>45,602</b>	<b>43,663</b>

Source: Volkswagen AG

prise is calculated on the basis of the present value of all future payment flows, i.e. the future payment flows are discounted under application of the current interest rate. Only the amount above and beyond what is required for the safeguarding of the total value of the enterprise is considered profit.

In the context of balance theory and its concepts of profit, a distinction has to be made especially between the profit of the static balance theory and that of the dynamic balance theory. The static balance theory defines the profit of a financial year as growth of assets. The dynamic balance theory aims, despite the time lag between deposits/disbursements and revenue/expenditure, to apportion to the financial year the appropriate success. This means that profit is calculated as the difference between the revenue and expenditure chargeable to that financial year.

In order to be able to decide whether an enterprise has worked profitably during a specific financial year, it makes sense to process the data contained in the balance sheet and the profit and loss calculation and to make comparisons. The examination of year-end accounts for the purpose of assessing

the financial situation and development of an enterprise is called balance analysis or, more appropriately, year-end analysis.

In the process of this analysis, it is customary to select certain figures for reference purposes; these also make it possible to compare relevant operational facts between enterprises that differ in size. The profit assessment usually starts with the balance sheet and profit and loss accounts, which are used to calculate the reference figures: equity returns, overall profitability and profit-turnover ratio. In practice, this tends to happen only after an extensive clearing of the figures.

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Marc Richard

## Property

An essential pillar of a functional →*social market economy* must be that not only labour and knowledge, but to a large extent also houses, land, equipment, factories, machines, money, securities, pension entitlements, etc., belong to individual people or are their own in such a way that they can decide what to do with them.

They can consume them or obtain →*income* from them. They can let or lease them, they can bond or sell them, or give them away or leave them to someone in their wills. They can use them to create jobs, change them or take them away. The right to dispose of money and objects at will – inherent in private property – is conducive to personal development as well as to family life (development and family function). Property of all kinds makes people's daily lives more secure. It gives more independence to the choice of a place of work – particularly if the property permits the establishment of a privately owned enterprise.

In a situation where property ownership by many is well developed, not only the respective owner but society as a whole benefits because this makes the →*market economy* possible. It ensures that, independently of one another, many decisions are made regarding the supply of goods and services, as well as regarding investments in new or modernised products and services.

This is significant because decisions always carry risks and uncertainties. They may be right, wrong or partly right or partly wrong. If all decision-making is done in one place and if this place decides wrongly, then everything

is wrong. If, however, many decide, then some decisions will be moderately wrong, some very good and many average, but gradually the best decisions will be copied and those which are not so good will be corrected. Private property offers the basis for independent decisions – but decisions, however, that are still in →*competition* with one another – and this is an excellent method of discovery for optimal and innovative solutions in the interest of the society as a whole (decentralisation function).

As well as forming the basis for competitive decisions, private property is an ideal motivation for taking good economic decisions and executing them well. It lets the owners and decision-makers watch their property grow thanks to profits arising from correct decisions. The fruits of their labours can be enjoyed or further investments can be made. The other side of the coin is that payment is required for bad decisions with capital or property losses (motivation function).

A further – and for many an even more important – advantage of private property is that it paves the way both to economic success and to political freedom. This is not only a consequence of economic self-determination or independence: important political fundamental rights, such as freedom of assembly and freedom of opinion, are best realised when rival political groups get private property; owners put assembly halls, newspaper columns and free air time at their disposal out of their own self-interest (freedom function).

The advantages of private property become particularly clear if the private property is juxtaposed to the collective property of entire nations. In what used

to be →*socialism* of the Soviet variety, the means of production (the material capital) were largely collectively owned. While this should have guaranteed equality, the truth was that it meant extreme inequality in that most of the more important economic decisions were centrally made by only a few people, who were keen to preserve their personal power. For this reason, and due to a lack of information, the decisions did not benefit the majority of people. They were deeply flawed, not very innovative and not inclined to motivate. What little had been put aside for investments was badly used. Dismal economic results were the result, and freedom disappeared behind walls, tanks and barbed wire.

The failed socialist experiment confirms theoretical research in institutional economic theory and also a Biblical rule. A centralised order is an option only if it comes from a wise and benevolent dictator, such as Joseph in Egypt, King David or King Solomon. Such an exceptional personality is not often at hand. In the Old Testament, the people of Israel received clear instructions on the organisation of private property, and this remains unaltered in the New Testament.

Article 14 of Germany's Basic Law guarantees private property. At the same time, it postulates that this should serve the well-being of the general public (society). The extent and limitations of actual ownership rights must be formulated in such a way that property is most profitable for owners when they are prepared to offer consumers satisfactory services, but not if they try to enrich themselves through market power, monopolies, cartels and price fixing.

The →*Act Against Restraints of Competition*, with all its restrictions to ownership rights, is a key component of the social market economy. Borders open to trade and global competition have the same effect (→*globalisation*) of counteracting market power. Other legal regulations, such as government duties, co-determine ownership rights. Taxes and duties are meant to ensure a degree of social equality. However, the motivational effect of private property must remain intact. Correctly, therefore, tax loads of more than half of a person's income have been declared unconstitutional.

The role of private property remains intimately connected with the fact that ownership rights are secure rather than arbitrary, even in the case of inheritance. This imposes limitations on inheritance tax. If property cannot be passed on in sufficient measure according to the will of the owner, not only will the motivation and family function suffer, but also the provision for the future in the form of accumulation of capital for society as a whole. If owners of private property can pass on only a fraction of their accumulated capital to their heirs, they will be more inclined to spend it on themselves than to save it for future generations. If, by contrast, property owners can as far as possible pass on property as they deem fit, they will feel obliged (property is an obligation) to ensure that the capital stock is sustainable ecologically as well as economically (the 'lastingness' function of the property). To think in terms of generations is the best guarantee of sustainable development because children, and property for the children, make sense only if life on this planet remains worth living.

Among the options property owners have is the detailed design of property rights by means of voluntary agreements. The joint property of several individuals can be vested in community of property in a marriage, trust funds or unincorporated firms. In large corporations, not much direct influence on the use of the property remains with individual shareholders. With the purchase of new shares, these shareholders nevertheless contribute to the decentralised decision-making process by assigning rights of disposal over capital to others. And, through the purchase or sale of actual shares, they influence share prices. This represents an assessment of the rights of disposal.

In the modern knowledge society, the significance of intellectual property is growing. There are greater opportunities of investing in oneself and through the appropriation of knowledge, of forming human capital. The young enterprises of the →*new economy*, mainly internet and biotechnology companies, largely consist of human capital into which outsiders can invest. Through credits or the purchase of shares, these outsiders enable such companies to develop their knowledge and to make useful new applications available in, for example, nutrition and health. The rights to intellectual property, partially secured by →*patents*, play a large role.

Certain expectations of the new economy turned out to be 'too much too soon'. The result was an adjustment of company values coupled with painful losses for investors, entrepreneurs and employees. This is an unpleasant and seemingly unavoidable side effect of the trial-and-error based process of innova-

tion driven by the independent decisions of private property owners. There does not seem to be an alternative to this scenario.

However, nothing will change the continually increasing importance of private property in the form of 'human capital' partly generated through education, as well as that of intellectual property partly generated through research.

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## Protection of freedoms

The freedom of the individual is a very valuable asset whose value is expressed in the fact that personal, constitutional and human rights have been given pride of place in the catalogue of rights at the beginning of the German Basic Law. These freedoms include: freedom of expression, religion, conscience, opinion and the press, academic freedom and the freedom to teach; freedom of association and movement; and free choice of occupation and place of work.

From an economic perspective, these rights include – as material prerequisites for free personal expression and human dignity – the consumer's

freedom of choice; contractual freedom; freedom of trade and business; professional freedom; and the freedom to realise personal goals through  $\rightarrow$ competition with others.

It is indisputable that human rights refer to all areas of life and that they can be reliably granted only in the context of a democratic state under the rule of law. The question of what type of economy should be combined with this political system receives less unanimous answers. This is probably due to the fact that the constitution does not contain any formally binding rules regarding the organisation of the economy. The idea of constitutional neutrality in relation to the economic system is nevertheless to be considered as a misunderstanding.

Any compatibility of a socialist centralised economy with the Basic Law has to be absolutely rejected. The concentration of political and economic power is an intrinsic part of this economic system (therefore inevitable). Centralised planning is basically synonymous with a blueprint for the future, implemented and controlled by means of binding rules and regulations. This will surely negate certain fundamental economic rights and liberties ( $\rightarrow$ socialism/planned economy).

From this comparative perspective, the conclusion is inevitable that only a  $\rightarrow$ market economy is compatible with the constitution. As a general concept, a market economy entails production processes based on  $\rightarrow$ individual responsibility, and the distribution and consumption of goods, including services, production factors and the matching of goods on offer and in demand, by way of exchange through markets and

prices. The economic agents are free to make their own decisions, to pursue their own personal goals and to benefit from their specific knowledge. The incentives inherent in these liberties must be seen as the actual reason for the dynamism and creativity of the market economy.

A free economy therefore also has a macroeconomic value. It results from the desire of individuals to plan and live their lives according to their own ideas, making the best possible use of individual skills and knowledge. The extent of the macroeconomic effect of this desire for self-determination is shaped by ethical and legal regulations. Absolute freedom always was, and continues to be, counterproductive since the individual expression of freedom is dependent on the interplay with the freedom of others. It is obvious that this conditional relationship equally applies to the economy.

A functional, humane market economy thus requires a deliberately designed order as well as a market-oriented economic and social policy. The  $\rightarrow$ social market economy strives to do this by pursuing an acceptable compromise between economic freedom and government-induced social balancing. Free markets require a legal framework that guarantees the inviolability of: private property; professional, business and contractual freedom; freedom of association; freedom to establish a business and to conduct foreign trade; and freedom of competition – to name some of the central pillars of economic liberty.

Freedom of competition is of crucial significance for economic efficiency. On the supply side, this entails free market entry for potential national or

international suppliers with the unfettered deployment of competitive instruments, meaning particularly the free planning of prices, products and other market determinants (quantity, quality) (→*open market: market entry, market exit*). The resulting market share and profit gains motivate competitors by forcing them to respond. This controls the dynamic of market forces as well as economic power.

On the demand side, freedom of competition takes the form of a wide selection of available goods for the satisfaction of individual preferences. This relationship between competition and results also applies on the factor markets, such as the labour markets. The cartel-like, binding agreements between the two sides of industry that control wages and other conditions in the workplace frequently hamper or prevent market and thus scarcity-related agreements between worker and management. Unintentionally, but unavoidably, this often leads to →*unemployment*.

Limitations to free trade, whether they are of private, corporatist or government origin, always go hand in hand with limitations to freedom. Thus for the protection of individual liberties a policy that actively promotes competition is important, as it is supposed to prevent or at least control the concentration of economic power on the supply and demand sides.

The tense relationship between market and freedom is mirrored by the relationship between →*social system* and freedom. As previously mentioned, →*social balancing* forms a central part of the concept of a social market economy. This concept has been incorporated

into the German economic system in the form of a complex labour and social institutional framework, and interconnected with a multitude of socio-political measures.

Here, the issue of concern is exclusively the controversial relationship between individual freedom and →*social justice*. The intellectual fathers of the social market economy considered both objectives as compatible, provided that measures and regulations in the realm of social policy conform to the principle of subsidiarity and market conformity.

Real-life →*social policy* in the areas of health, social security, housing, the labour market and educational and cultural policy in Germany does only partial justice to these principles (→*social state* and *welfare state*). In many instances, →*individual responsibility* and freedom have been replaced by comprehensive social security interventions. Due to changes and challenges on a global scale, however, these have now met with inescapable financial and ethical limitations.

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### **Protestant social ethics**

Ethics refers to the doctrine of righteous human actions and behaviour and a commitment to human responsibility.

The word social – derived from the Latin *socialis* (*socius*, originally meaning ally) – has undergone a marked concep-

tual shift. 'Social' originally referred to man as a social creature (*animal sociale*) and the fact that human beings live together, above all in the home (*vita socialis*: St Augustine). During the Middle Ages (Thomas Aquinas), social became synonymous with political. By the beginning of the Modern Age, however, sociality (*socialitas*) had developed into the fundamental concept of a rational doctrine of natural law (→*liberalism*).

Since the 18th and 19th centuries, the meaning of the word social became transformed again, in two different ways:

- J. J. Rousseau formulated the idea of a social contract (*contrat social*, or rather *pacte social*). The term social is now distinct from the term political; in other words, the distinction between society and state has taken root. Society and economy are liberated from state control and grow into independent areas of life.
- The term social is particularly closely connected with the social consequences and problems of the industrialisation and of early capitalism. New concepts, such as the social question (which used to be referred to as the question of the working class) are proof of this development. At the same time, new composite words arose, such as social movement, social organisation, social revolution, →*social justice*, →*social policy*, →[*social*] *welfare state* and social law. Social issues are usefully brought up when demands for social equality and solidarity are formulated. Inequality is referred to as unsocial.

Through its expansion, the word social gained a dual tension – the tension between individual and society, between individualism and collectivism; and also the distinction from community in the sense of interpersonal in a linguistic usage which understands social in terms of social institutions, social facilities. Social ethics, too, makes use of this blurred definition of social.

The social sciences, and especially sociology, are sciences that came into being with the Age of Enlightenment and as a result of the social consequences of the Age of Industrialisation.

Protestant social ethics was born out of sociology, or the empirical social sciences. The Lutheran theologian Alexander von Oettingen, who was then teaching in Dorpat (today's Tartu in Estonia), was the first to use the term 'social ethics' in the title of an 1867 book. He makes reference to moral statistics, which prove the existence of a social order. Through the neologism social ethics, he endeavours to distance himself from an exclusively mechanistic definition of social processes (social physics, social determinism) while also taking a stance against a purely one-sided view of ethics as referring only to individual and personal acts.

This means that the term social ethics has to fulfil a dual function: on the one hand, scientific description and the analysis of social processes is to be linked with evaluations and normative judgments (prescribing). This question can also be interpreted as the epistemological distinction between what is and what ought to be (= reality and ideal). On the other hand, social ethics is about the consideration and evaluation

of social structures, institutions and organisations, which are generally called orders or institutions: examples are marriage and family, →*property*, labour, the state, the law, culture and academic institutions. In this regard, questions such as the following become evident:

- Are there structures and conditions in science, politics and social ethics with their own inherent laws? This controversial idea of the existence of inherent laws, defines ethical actions through their limitations and conditions.
- How can structures be changed?
- How can individuals influence these structures by their actions?
- How can responsibility be practised in social institutions?

In addition, community – natural circumstances, such as the bio-social concept of marriage and family – has to be distinguished from society, i.e. man-made organisations (such as →*enterprises*, trade unions and associations).

The breadth and indefinite character of the term social ethics leads to a large range of socio-ethical ideas and concepts. Behind each example of social ethics is a social model, a social theory.

Often, such models are not explicitly named; they are akin to ideals and utopias. Such a model can, for example, be the classless society, the capitalist →*market economy* derived from liberalism, a responsible society, a society with an ecologically sustainable economy or

the →*social market economy*. It is the task of academics to conduct a critical examination and investigation of the philosophical principles and objectives of all these examples. This is why social ethics is a discipline that is easily transformed into an ideology.

The basic principles of social ethics are often debated by theologians. The Catholic Church postulates a universally binding natural law, and thus presupposes a social philosophy. Protestant social ethics refers to the Bible. In this context, a number of different models of thought may be used for guidance. The Lutheran tradition, for example, makes a distinction between divine rule in the worldly realm and God's spiritual rule over the community of believers, the Church. The worldly rule must be measured by reason.

The reformed point of view, or the view promoting social transformation (such as religious socialism), sees the kingdom of God as a socially transforming force able to bring about a world of peace, justice and support for the poor.

Protestant social ethics therefore represents a variety of social ideologies and uses various arguments (it refers, for example, to causes of reason or to religious postulates of obedience). Social complexities and the variety of cultures (pluralism) are thus reflected in a number of stances adopted by social ethics.

The need, however, for theology and the Church to participate in public discussions on social, economic and political events and objectives is uncontested. It should be seen as a public appointment for the involvement with social or rather universal issues.



In addition, there are now many statements and declarations by the Church (commemorative volumes) on social topics, and there is increasingly more understanding that expertise (factual comprehension) has to be seen as a prerequisite of programmatic demands. This is why a global social theory (social ethics) has become more and more divided into ethical areas (such as ethics of economy, ethics of technology, bioethics, ethics of science, international ethics and political ethics). There is still a need to design a comprehensive social theory, an overview of social imperatives.

Lastly, an important fundamental question remains: Who should be seen as representative of a system of social ethics and who should be targeted? Is it the believers, the Church? Is protestant social ethics an ethics of ecclesiastical responsibility, or does it apply to culture as a whole by claiming to make universally comprehensible and universally binding suggestions?

It follows that protestant social ethics has to engage in an ongoing review of its own position, without forgetting to include the Church and the question of its own concept of itself.

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## Public debt

Apart from public dues (taxes, fees, contributions) and acquisition income (from  $\rightarrow$ public enterprises), incurring public debt benefits the attainment of income of the federal government, federal states and municipal budgets. The public debt is characterised – in the same way as acquisition incomes, though different from taxes (due to coercion in this case) – by the voluntary nature of the funds contribution, if one disregards the case of a mandatory loan (equal to a tax with a repayment claim).

Market economy principles apply: as demanders in the money and capital market, the public authorities are competing with the private loan demanders in that arena. The capital suppliers (domestic banks, institutional investors, private households and  $\rightarrow$ enterprises, as well as corresponding investor groups abroad) relinquish their liquidity (capital) to the state in return for market interest. The funds from the debt (treasury notes, treasury bills, financing treasury bonds, federal treasury notes, bonds) have a limited duration; they are to be repaid to the creditors through redemption payments.

The national debt generally serves the purpose of adjusting the temporary imbalance of revenue and expenditures of the public budget. On the one hand, the purpose is to bridge a current short-term liquidity deficiency of ways and means advances. On the other hand, the funds are used to finance expenses in the form of covering loans.

The national taking up of credit has to be differentiated between net and gross raising of credit: net borrowing is the part of the entire credit raising (gross

raising of credit) that is not applied to debt repayment (follow-up financing), but rather is being used to finance new expenditure (new net borrowing).

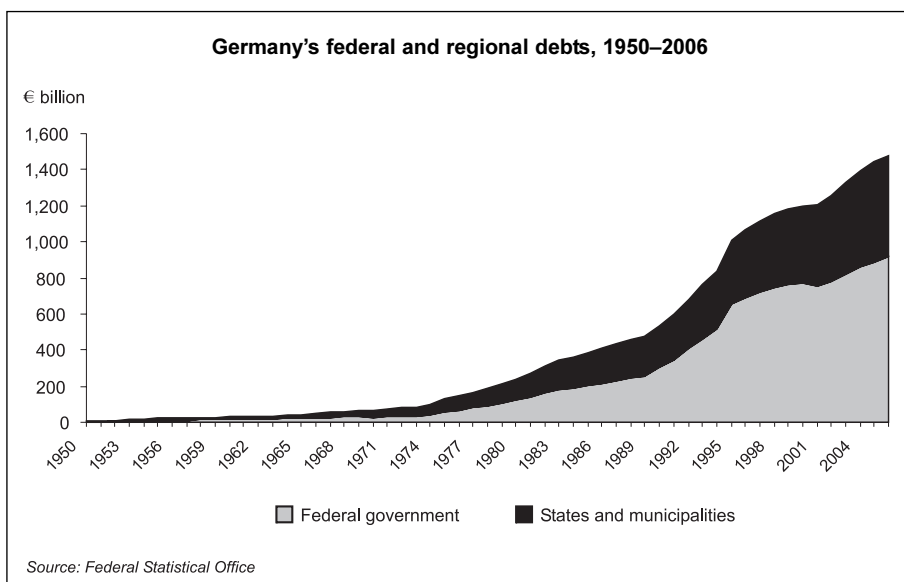
Through debt, the public authorities not only expand their present scope of action but also assume future obligations in the form of the debt service (interest charges and repayment). It is for this reason that public accumulation of debt is bound by legal norms (debt restrictions).

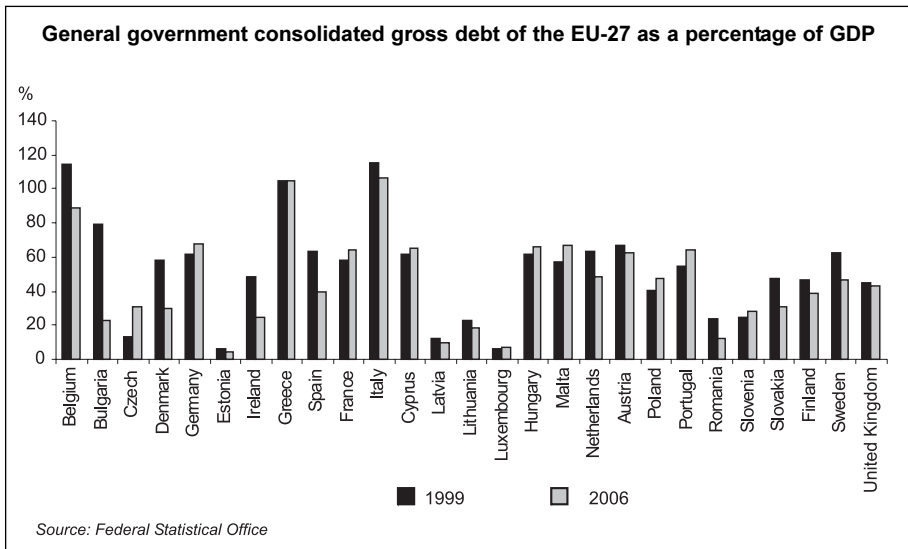
Article 115 (1) of the German Basic Law and paragraph 18 of the federal government budget regulations governing state credit financing prohibits new net borrowing exceeding the sum outlined in the budget for investment expenditure. Exceptions are permissible only when protection against a disturbance of the macroeconomic equilibrium is required. Furthermore, similar restrictions are outlined in the European Union Treaty: according to the budget criteria of the treaties of Maastricht (1992) and Amsterdam (1997), new net

borrowing may not exceed 3% of gross domestic product (GDP) and total debt may not exceed 60% of GDP (in each case at market prices) (Article 104 of the EC Treaty in connection with the protocol on the procedure to deal with an excessive deficit).

Above all, the national debt pursues the fiscal objective of raising funds. Beyond that, non-fiscal objectives are also envisioned: concerning the stabilisation and the growth objectives, the funds are used to support market performance by implementing activities to improve demand or supply.

The objective of inter-generative burden-sharing is based on the concept of financing the state's capital expenditure (for example, for infrastructure) through debt, as its use on behalf of citizens extends over a longer period of time. In this way, future generations which are the beneficiaries of a current investment expenditure will have to pay the debt service by future mandatory taxation. Thus, the timing of the distri-





bution of use and burden is harmonised.

But public debt also fulfils a political objective in the sense that citizens pay less attention to this sort of revenue than to tax increases; and this means that there is less resistance from the population. It is true that this improves the re-election chances of politicians. The shortsightedness of this policy, however, ignores the future interest and repayment obligations, and the restricted room for manoeuvre that is their long-term consequence. This allows the indebtedness to grow to the point where a budget consolidation (decrease of new net borrowings until a budget surplus has been achieved, allowing the net repayment of debts) becomes inevitable. Usually, this requires a restrictive financial policy with all the consequences for citizens who are used to being pampered.

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### Public enterprises

In its role as service provider, the state makes use of its administrative apparatus (offices and authorities) and a great variety of disincorporated organisations which work along company lines, all the way up to commercial →enterprises as they are found in the private sector. If they are government-owned or administered, all of these fall into the category

of public enterprises. There are essentially four different motives underlying the establishment of such public enterprises.

***Services that could in principle be satisfied by the open market***

For political or financial reasons, these services are produced or offered by the state. Depending on the kind of organisational structure concerned, these services are provided by state administered or publicly managed independent enterprises, which are either state owned or which have been disincorporated. The former are not self-administered and their revenues and expenses are incorporated into the general budget (for example, an in-house printing works or a gardening department).

Publicly managed enterprises, once they have reached a certain size, assume the status of independent organisations as a way of avoiding the inflexibility inherent in state administration. For this purpose, their assets are disincorporated from the public budget, a separate accounting is established and a responsible management. But these enterprises have no legal independence; their services for other administrative units are generally charged at prices exclusive of a profit margin, merely covering costs, and are then listed in the general budget of the government level concerned, with the annual remittance of profit or coverage of losses. Typical examples of this form of public enterprise are local transport companies and suppliers of electricity.

***Other goods and services classified as public utilities***

These are services of supply and dispos-

al that rely on a network-like infrastructure for transport (for example, railways, waste water disposal). The high fixed costs and the resulting long-term average cost decrease make these services relatively unattractive to private enterprise. Alternatively, the supply of public services (public goods) through private enterprise may be unsuccessful because users tend to be unwilling to pay for them on an individual, voluntary basis, for example, street cleaning, fire insurance. The legislator reacts to these imperfect market conditions by authorising the relevant administrative bodies to make user-subscriptions or fire insurance compulsory.

Apart from the legally dependent government-owned enterprises already mentioned, such services are typically provided by legally, organisationally and economically independent enterprises, some of which are classified as →*paras-tatals*. Organisations led by membership, such as →*chambers* and guilds, are constituted as bodies of the public law. For the sake of certain non-profit causes which transcend the day-to-day political agenda, it is possible to establish public law foundations whose funds are tied to a specific purpose (for example, the German Consumer Foundation ‘Stiftung Warentest’ and the German Federal Foundation for the Environment).

***The services on offer can have a political motivation***

This is the case in areas where market supply is usually easy or at least possible, but where, for political reasons, a qualitative and quantitative adjustment of the outcome is on the political agenda. These publicly offered goods are

called merit goods. If they are customer-based institutions, they tend to be registered as institutions of the public law (examples: savings banks and regional banks, public radio and television stations).

### **Commercial activities**

Finally, public enterprises can also be potential candidates for commercial activities, which offer goods or services at prices that either cover production costs or yield a limited profit.

Such ventures can, or are supposed to, express the official reasons for production; they also tend to adopt the same legal and organisational forms as private enterprises. This more commercial approach goes hand in hand with easier adaptability to changes in the market, as well as more productivity and profitability. It is, however, harder for the state to exercise influence and control. And while it is true that in looking for business returns (without profit limitations), the political objectives tend to take the back seat, the next step is the  $\rightarrow$ privatisation of public enterprises and the creation of a leaner state.

Generally, it would be desirable to see public enterprises that are operating more or less outside the confines of the main budget (of the  $\rightarrow$ Federal Republic, federal states and municipalities as well as the  $\rightarrow$ EU) being forced to greater transparency and more detailed reporting. This would give the respective government authority in charge more insight into their activities and how successful they are. This is the only way of actually making purposeful, detailed political policies a reality. Furthermore, only in this way can public enterprises avoid unacceptable losses and, through

their below-cost prices, cause a massive upheaval in the market of private suppliers.

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## **Public expenditure**

In a  $\rightarrow$ social market economy, certain services that benefit the public are provided by the state because the market does not supply them in a satisfactory way. These services in their different forms are the way the government participates in the economic process.

- On one hand, these apply to interventions which influence the private supply and demand in the form of laws and regulations without having a direct impact on the budget.
- On the other hand, they concern the collection of taxes and levies and the expenditure of public means, which does have a considerable impact on the budget.

With a view to the  $\rightarrow$ market economy, there is above all the expenditure that goes to the preservation and security of the state and to the protection and free development of the market. This expenditure forms a considerable pro-

portion of the overall national expenditure, such as that spent on defence and on the judicial system.

In terms of precisely where the money goes in the economic production and distribution process, public expenditure can be further divided into public administrative expenditure (personal and material expenditure) and cash payments (transfer payments): administrative expenditure includes remunerations for services in the factor and goods markets (salaries or remuneration for civil servants and public service employees, and material expenditure for current necessities and for investment purposes).

The resources going to the public sector are no longer available to the private sector. For cash payments (transfers to private households,  $\rightarrow$ subsidies to private enterprises), nothing is offered in return apart from the adherence to certain conditions regarding the receipt and the utilisation of payments. The consequence of such payments is a redirection of the purchasing power without any direct utilisation of resources being made (such as  $\rightarrow$ social security benefits in the form of transfers to private households for the purpose of improving their specific financial situation; subsidies for enterprises for better  $\rightarrow$ environmental protection).

This public expenditure classification is the basis of an analysis of its macroeconomic effectiveness and the extent to which objectives are met. It is to be investigated how a change of the volume of expenditure on the one hand, and a change of the structure of the expenditure on the other affect  $\rightarrow$ price level,  $\rightarrow$ employment, structure and  $\rightarrow$ growth of the economy, as well as for-

eign trade relations and income distribution.

At the core of this sort of analysis tends to be the effect of public expenditure on demand. It is assumed that public expenditure for the purchase of goods is passed on to the market in its entirety and has an immediate effect on demand, while transfer payments are only partly and indirectly converted into market demand by their recipients, since at times part of the money is saved. This is relevant to the description of the so-called multiplier and accelerator effects: since additional demand turns into  $\rightarrow$ income for the suppliers (primary effect), a certain part of that translates into demand a second time because these persons equally spend a part of their income (multiplier effect). The renewed income formation arising from the secondary effect closes the circle.

The demand stimulus triggered by public expenditure usually does not correspond precisely to the amount spent, but can deviate from this upwards (such as in the case of subsidised interest as an incentive for investments) or downwards (such as in the case of staff remuneration and proportional savings). But public expenditure can also be supply-orientated, such as in the case of educational expenditure or fund allocation for the promotion of research.

In view of the effect on macroeconomic productivity increase, public expenditure can also be classified as either investment or consumptive. The former usually ranks more highly in macroeconomic terms. But it is important to note that investments involve certain ancillary costs which represent

consumptive expenses. This means that the growth of public capital assets also entails growing consumptive expenses. It also has to be pointed out that the differentiation between capital and consumptive public expenditure has important repercussions for the permissible limit of net new borrowings as part of the public revenue (→*public debt*). According to Article 115 of the Basic Law, this must as a rule not exceed the amount of the investments.

The sharp rise of public expenditure over the past several decades has led to an increase of the government ratio as a proportion of public expenditure in the gross domestic product. Since the rise of public expenditure has also led to higher tax and social security contributions as well as to an increase in the public debt, severe political and economic problems have been the consequence.

The public financial system is losing its credibility regarding its adherence to the market system. This is based on the idea that market forces have preference before government interventions (→*interventionism*). At the macroeconomic level, the growth and employment potential of the private sector are weakened by excessive taxes and levies.

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## Public revenue

For the active implementation of their public functions, the regional government authorities are dependent on continuous public revenues. Thus, the primary function of this revenue is a financing function. The most important sources of revenue for public budgets are taxes. These are used to finance comprehensive state functions. In particular, they are used for public services (public goods) whose use and payment cannot be attributed to an individual citizen (examples: internal and external defence) or based on a political decision for public goods whose payment by an individual user may not be desirable (examples: schools, studies). Thus, taxes are a mandatory contribution on behalf of the citizen for which they do not have a right to a specific immediate service in return.

Accordingly, taxation can be tied to criteria – primarily the capability of the taxpayer (ability-to-pay principle). References for taxation can be found in the →*circular flow of incomes* in the economy. Taxation occurs, for example, in the case of the trade or corporate profits where the factors of production (labour, land, capital) are implemented for the generation of goods. Personal income generated (wages, salaries, interest)

<b>Distribution of taxes and contributions in Germany, 1965–2006</b>				
in percent (%)				
<b>West Germany</b>	<b>Federal government</b>	<b>States</b>	<b>Municipalities</b>	<b>Others*</b>
1965	55.3	30.7	12.4	1.6
1975	49.2	34.0	13.8	3.0
1985	47.2	35.3	14.1	3.4
<b>Germany</b>				
1991	48.0	34.4	12.8	4.8
1995	45.0	38.1	11.6	5.3
2000	42.9	40.3	12.2	4.6
2005	42.1	39.9	13.2	4.8
2006	41.7	39.9	13.8	4.5

\* Others: LAG, EU-Proportion, customs duties  
Source: Federal Ministry of Finance

attracts taxation in the form of tax on wages and income tax as well as investment income tax and withholding tax on interest.

In addition to income, consumption is taxed by a general value added tax (VAT) as well as through a multiplicity of specific taxes (such as fuel tax, electricity tax, sparkling wine tax, tax on tobacco) to finance the public budget. These are taxes on the flow of yields being continually generated.

Apart from the real estate tax, Germany no longer taxes private property. Taxation is limited to asset transfers of property (donations, inheritances) as well as to the purchase of land. The taxation of imports of foreign products through tariffs is of decreasing importance as these are continually being lowered internationally. Thus, tariff payments in this context belong to the category of direct revenue of the European Union (→EU: *budgeting*).

The distribution of tax revenue among regional government authorities depends on the assigning of rights to determine the form and amount of tax

(collection competence) as well as the right to use the funds for their own budgets (revenue competence). In Germany, these competences are structured in a very complicated manner (→*fiscal federalism*). Besides taxes, factor incomes are charged in connection with the voluntary or designated use of specific public services.

If the use is of an individual nature with a traceable immediate personal benefit, the payment is made in the form of fees. These fees are incurred with the use of a public facility (examples: toll roads, tuition fees) or an administrative facility (examples: court fees, civil registry office fees) or for the transfer or conferment of certain utilisation rights (examples: franchise tax, royalties).

Depending on the aims and objectives of the state service provider, the calculation of fees can be set according to:

- the politically desired demand;
- the production costs; or
- the price the users are willing to pay.



Increasingly, the rule regarding the amount follows the market (i.e. the price that is determined by the utility of service for the user) (equivalence principle).

The financing of public services whose utility can be assigned to a group is financed through dues payable for the user. Payment is not always based on actual use of the service; it is sufficient to illustrate that a restricted group has the possibility to benefit. Here, too, political motivation can be at the root of the contribution amount, as when the cost of the use of a kindergarten varies according to the number of children in a family or the income of the family. The desired revenue structure may not be sufficient to cover the cost: this is a feature of needs-orientation of public service provision and the corresponding and connected public interest (real transfer). Contrary to this motivation are profit-oriented private enterprises aimed at cost efficiency and profit. This would be equivalent to an additional tax.

To a limited extent, government authorities also pursue financial gain, particularly in the form of  $\rightarrow$ public enterprises and state investments, which may earn additional income in the form of profits and other capital proceeds. An example is the profits that accrue from the participation of the  $\rightarrow$ German Federal Bank in the European Central Bank, despite the fact that the bank's activities are generally not aimed at the accrual of profits. In addition, the treasury may derive one-off capital gains from the privatisation of public assets or licence sales.

Public borrowing ensures that the remaining gaps between revenue and

expenditure are closed. In the event of temporary financial difficulties, short-term cash advances (or in the case of a longer-term deficit, medium-term operating loans) are granted. In the case of the latter,  $\rightarrow$ public debt can, besides serving a fiscal purpose, also fulfil another function: it is a way of financing additional, or stabilising,  $\rightarrow$ public expenditure aimed at balancing a lack of demand in the economy as a whole and phases of economic weakness (recession).

Debt may also make it possible to create a balance between today's and future generations, if investments are financed in this way. The investments yield their benefits when the debts plus interest are being paid, i.e. future generations harvest what has been sowed, but they also have to service the debt and carry the burden of the investment.

Financing through debt becomes problematical when the present generation derives the benefit (consumptive expenses being covered), while the burden of repayment falls on a later generation. Moreover, high debts can substantially restrict the flexibility of a budget if interest payments and repayments swallow up a large proportion of the tax revenue.

Besides providing a financing function, public revenue can also be used as an instrument to control the public services (control function). In this context, revenue may be of secondary importance. In such cases, the individual and general economic consequences of the collection of revenue can be seen as interventions for the purpose of achieving certain specific objectives (example: the environment tax for reduced energy consumption with

simultaneous compulsory allocation of the collected revenue for →*pension insurance*).

Theoretically, steering or control taxes could be implemented for the government's entire target bundle. The

plethora of resulting overlapping effects would, however, not only blur the general view but would also have a negative and disruptive impact on the →*market economy*. This is why allocation-oriented taxes are very controversial.

**Income tax plus employee and employer social security contributions, 1998 and 2006**  
in percent of labour costs\*

Country**	1998				2006			
	Total tax wedge	Income tax	Social security	Labour costs***	Total tax wedge	Income tax	Social security	Labour costs***
United Kingdom	32	15	17	29,277.34		16	18	55,171
Belgium	57	22	35	40,995.55		21	34	54,896
Germany	52	17	35	35,863.53		18	35	54,129
Austria	46	8	38	29,823	48	12	36	51,075
Luxembourg	34	10	24	31,102.37		12	25	49,944
France	48	10	38	28,198.50		11	39	49,813
Netherlands	44	6	38	32,271	44	12	32	48,986
Sweden	51	21	30	29,768.48		18	30	46,396
Switzerland	30	9	21	32,535	30	10	20	46,196
Norway	37	19	18	31,638.37		19	18	45,337
Finland	49	22	27	29,334.44		19	25	44,693
Japan	20	6	14	27,664	29	6	23	44,469
Korea, South	15	1	14	22,962	18	3	15	43,729
Australia	25	24	1	29,590.28		22	6	40,770
Greece	36	2	34	17,880	41	7	34	39,243
Denmark	44	34	10	32,214.41		30	11	38,956
Iceland	25	20	5	22,545.29		23	6	36,775
Italy	47	14	33	32,351.45		14	31	36,585
Canada	32	20	12	32,211.32		15	17	36,137
Spain	39	11	28	24,454.39		10	29	35,209
United States	31	17	14	31,300.29		15	14	35,045
Ireland	33	18	15	24,667	23	9	14	32,945
New Zealand	20	20	0	24,332.21		21	0	28,346
Portugal	34	6	28	13,903	36	8	28	25,849
Turkey	40	21	19	15,825.43		13	30	24,993
Czech Republic	43	8	35	15,781	43	7	36	21,777
Hungary	52	12	40	9,916.51		15	36	19,685
Poland	43	11	32	12,696	44	5	39	19,130
Mexico	22	0	22	8,662.15		3	12	11,026

\* Single individual without children at the income level of the average worker

\*\* Countries raised by decreasing labour costs in 2006

\*\*\* Dollars with equal purchasing power; total annual labour costs for the employer

Source: OECD: Country submissions; OECD Economic Outlook

Generally speaking, the amount and structure of taxation (tax and contribution ratio or taxation ratio) are important for each citizen. They determine the level of the residual income and →*profits*, and thus also the margin remaining at the disposal of the citizen. This also applies when the tax burden is directly compared with the associated public expenditure as fictitious return. In a market economy, personal decisions are of primary importance and have to be seen as an indirect limitation of the public tax burden that needs to be taken into consideration.

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## Public-private partnerships

A public-private partnership (PPP) is a special way of implementing and controlling public functions through cooperation between government authorities and private investors. For many years, PPPs have been at the centre of a heated debate, which was prompted by the recognition that public services are in need of restructuring.

The debate is still relatively new in Germany, but it is gaining in relevance because of the scarcity of public means. Public-private cooperation originates

in the United States (US), where such forms of cooperation have existed since the 1940s. Since the 1970s they have been involved as a significant element of the public activities in that country. At that time, the US had an enormous number of problems and the public sector, with its antiquated structure, could no longer cope with these. In the course of the economic stagnation and simultaneous inflation (stagflation), the federal government withdrew from its services, which caused the problems facing the municipalities to grow further. After a dramatic breakdown, a large number of reforms were introduced, which ended the sharp demarcation between state and private sector function, and which led to intensified cooperation between public authorities and private investors.

There is a great deal of literature on PPPs, but a clear definition of the term does not exist. The list of the possible fields of application is long. PPPs are possible in urban development, the transport sector, housing construction, cultural institutions and the education sector, as well as in the provision of internal and external security and defence. Besides the great variety of possible projects, the project size can vary greatly as well, and there are countless PPP possibilities in the education and transport sectors.

Despite the heterogeneity of the term, PPPs have to be distinguished from the term →*privatisation*. As the term 'public-private partnership' already suggests, this form of cooperation is situated in-between governmental activity (execution of a task by the state itself) and material privatisation (pro forma and actual transmission of

public vested titles and activities to private investors). The term would be less succinct if it denoted any possible cooperation between the state and →*enterprises*. To equate PPPs with privatisation could conceivably lead to positive effects of the PPPs being left undiscovered, since privatisation became an emotive word in the current economic policy debate. A definition of the term PPP should therefore be not as broad as possible but as narrow, and thus as precise and appropriate, as possible.

Due to the large number of possibilities of application, the specific area of application is not a suitable criterion for definition. But the conditions for PPPs are of great importance. Cooperation is by its nature voluntary. Goal compatibility and the possibility of obtaining synergy effects are therefore crucial criteria for definition. A partnership is therefore possible if both sides achieve goals that they would not achieve alone. If one defines PPPs on this basis in the narrow sense of the word, the following applies: a PPP is a form of interaction between government actors and private investors focused on the pursuit of complementary goals and the realisation of the synergy potential of cooperation. The partnership is process orientated, whereby the identity of and responsibility for each side's own actions remain intact. The partnership relationship is contractually laid down.

PPPs offer many opportunities both for the public authority and for the investor. This can largely be interpreted as the realisation of synergy effects. There are a number of variants of the mutual advantages. For the public authority, these include the transfer of the operational risk of the production of

public services to private investors and the possibility of saving costs through a more efficient private supply of the services concerned by these private actors. The private investor is mainly interested in the realisation of profits. But quite differently, non-materialistic motives such as an enterprise trying to advertise its public image, may also play a part. By and large, it is a win-win situation for both sides.

It would be wrong, however, due to the opportunities of public-private partnerships, to regard PPPs as a panacea for the government's urgent funding problems. The risks of this sort of cooperative venture do not allow that. Apart from the problem of asymmetrical information distribution between the partners, there is also uncertainty about the quality and efficiency of the private investor. The long life of many contracts makes this a particularly important issue. Beyond that there is a danger of moral hazard due to diverging motives. There is also the risk that should the two contracting parties incur financial losses, these will be passed on to a third party (the citizen) in the form of higher fees (rent seeking). This brings up the question about democratic legitimacy, since control mechanisms are largely lacking.

Thus PPPs have to be made to comply with a number of important conditions. The first is goal complementarity, and moral hazard behaviour and the exploitation of third parties has to be prevented. This requires contractual control and enforcement mechanisms. PPPs should also not simply be copied, but the individual requirements of the respective project must always be considered. In order to be successful, PPPs

have to conform to strictly market and outcome-orientated principles, which are reflected in a clear process structure and an appropriate project organisation. Underlying power structures and any incentives inherent in a project and problems have to be disclosed, thus making it possible for the rules of the partnership to be clearly spelled out in the contract.

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## Reconstruction East

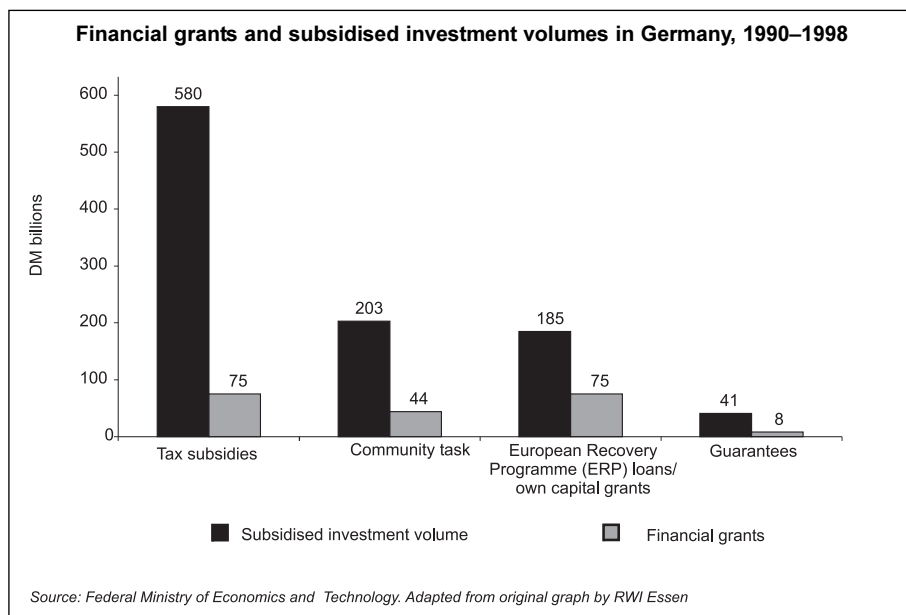
After German reunification, the main goal was to adjust East German living conditions and opportunities to those of West Germany as quickly as possible. This was considered feasible only on condition of the establishment of a productive East German economy, which, however, after the introduction of the monetary, economic and social union, initially underwent a dramatic breakdown. Until the beginning of 1991, industrial output shrank by 70%. The various measures of the Reconstruction East programme were therefore aimed at reviving the East German economy, not least in order to prevent a threaten-

ing massive exodus of East Germans to West Germany. These measures were modelled on West German experiences in the industrial and regional promotion of the economy.

Financial assistance in the form of capital investment grants, securities, soft loans and tax concessions – such as accelerated depreciation (→*subsidies*) – were meant to stimulate private investment and business start-up activity (see *figure, next page*), while initially also smoothing the path to privatisation of former state enterprises (→*Treuhand Privatisation Agency*). Furthermore, the creation of research and development institutions was and is being promoted, comprising in this instance also non-corporate or tertiary research institutions (such as the Max Planck Society, Blue List institutes, the Fraunhofer Society).

The speedy modernisation of the inadequate infrastructure, with particular emphasis on the areas close to the economy (such as transport, telecommunications, business parks), was intended to help the economy catch up. So-called soft location factors, such as housing, urban planning and environmental protection, were part of this process. Social and labour policy measures (such as employment creation, social plans, early retirement), were supposed to make the transition period easier for the people.

→*The Federal Republic, federal states and municipalities* as well as special funds – European Recovery Programme (ERP) special assets, the →*Treuhand Privatisation Agency*, and the German Unity Fund (→*Redemption Fund for Inherited Liabilities*) – were used to fund this assistance.



Tax revenue from the federal government, federal states and municipalities, as well as income from social security contributions (pension and unemployment insurance) in East Germany, were of course insufficient to fund the reconstruction in the East and its social alignment. This made transfers from West Germany necessary. These fluctuated between €77 billion and €97 billion a year, depending on which payments were included and how they were calculated in each case (Heilemann/ Rappen 2000, p. 12ff.). These transfers were largely allocated to social alignment, in particular compensating the East German deficits in unemployment, health and long-term pension schemes, but also to the funding of public services in East Germany.

The Reconstruction East programme was quite successful, provided that the unrealistic initial expectations are not used as a benchmark. On paper, per capita gross domestic product

(GDP) for East Germany including Berlin was expected to increase from slightly more than 49% in 1991 to approximately two-thirds of the West German level. This convergence, however, is the result of a passive rehabilitation, partly due to considerable losses of population during the period of time examined (–5.4%).

The infrastructure is assumed to have reached two-thirds of the Western level by now. The adjustment of income levels has continued. While in 1991 monthly wages and salaries before tax averaged only 48% of those of their West German counterparts, by 1998 they had already gone up to 78%. If tax payments made by, and transfer payments received by, each household are included in the calculations, then East German households have reached 87% of the Western level. In 2002 the remuneration of employees amounted to 81.5% of the Western level.

Despite these remarkable successes,

it must be stressed that East Germany is still a long way from full socio-economic parity with West Germany. It is expected that this will take at least a further generation.

This accounts for the decision to continue the solidarity pact, which contains two elements or rather baskets, in place post-2005. The Supplementary Federal Grants for Special Requirements (SoBEZ) comes out of what has been designated as Basket I and is targeted at upgrading East Germany's previously inferior infrastructure, as well as giving the proportionally under-funded East German municipalities a financial boost. This will be for a limited term only and will decrease over time. The allocations amount to a total of €105 billion for the period 2005–2019.

In Basket II, the federal government pledges that the East German states, relative to those in the West, will continue to receive more than their proportional share in aid for Reconstruction East. A total amount of €51 billion has been earmarked for this purpose, although it has not yet been officially approved. At present, Basket II comprises extra payments by the federal government for common (joint) tasks of the →*Federal Republic, federal states and municipalities*, financial aid, money derived from the EU Structural Fund, as well as the federal share in the Investment Bonus East.

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### Redemption Fund for Inherited Liabilities

The assumption of existing and new debts as a consequence of the German →*reunification* was largely accomplished through newly established special assets of the Federal Republic. The so-called Debt Processing Fund took on the debts of the German Democratic Republic (GDR) national budget from the time of reunification. Banks and business enterprises were granted compensation claims against the Currency Conversion Equalisation fund in order to adjust their balance sheets. This was necessary since the conversion of assets (demands) and liabilities (commitments) from the GDR Mark to the Deutsche Mark was not 1:1.

The banks were granted further compensation claims to make amends for the requisite deductions of claims against →*enterprises* that were beyond repair and to increase their own capital funds to 4% of their balance sheet total. The liabilities of the Equalisation of Burdens Fund were equally integrated into the Debt Processing Fund. Furthermore, the →*Treuhandanstalt* was established for the →*privatisation* of profitable, and the dismantling of non-

profitable, enterprises. But the *Treuhandanstalt* was unable to offset the associated expenditure (among other things for the assumption of long-standing credits, investment aids and social plans) with the proceeds of sales (privatisation of enterprises), so that its final balance sheet in 1994 showed liabilities of €105 billion.

In 1995, the Redemption Fund for Inherited Liabilities, as a newly created special asset of the Federal Republic, assumed the liabilities of the Debt Processing Fund and of the *Treuhandanstalt*, but also the standing commitments of East German housing enterprises and private landlords. Furthermore, the compensation claims that have arisen since 1995, as well as those which are continuing to arise, are also integrated into the fund. The liabilities of the fund will probably rise slightly due to further exoneration according to the Accumulated Debt Assistance Act.

The fund is administered by the Federal Ministry of Finance and the federal government is responsible for its liabilities. In this way, in the wake of reunification, a far-reaching consolidation of the special assets was achieved. In the long run, only assets in a special position were permanently excluded: the Federal Railroads asset, into which the long-standing debts of the National Railroad (the GDR) and the Federal Railroads were transferred, as well as the German Unity Fund, whose interest and repayment obligations are carried by the federal government and the West German states and their municipalities.

Starting from 2005, in terms of the restructuring of financial equalisation, the federal government will assume the

annuities of the German Unity Fund up to its dissolution at the end of 2019. In return, it receives a fixed portion of value-added tax arising of almost €1.32 billion. The existing balance of debt at the time of its dissolution of up to €6.54 billion is transferred to the Federal Republic in its entirety; the West German states (including West Berlin) make a 53.3% contribution to amounts higher than that.

While up to the end of 1994, long-standing interest and redemption obligations of the liabilities resulting from the reunification were financed by new borrowings, the liabilities of the Redemption Fund for Inherited Liabilities are being systematically reduced. From 1995 to 1998, the fund received contributions of €46.7 billion from the federal budget (initially annually 7.5% of the gross liabilities of the fund) as well as €12.8 billion in Federal Bank profits (that part of the Federal Bank profits which exceeded the amount of €3.5 billion). In this way it was not only possible to settle the interest due, but also to reduce the existing liabilities by approximately €25.1 billion.

The Redemption Fund for Inherited Liabilities did not only erase debts, but in 1997 it also assumed municipal liabilities for the construction of social facilities. In return, the new German states pay the federal government €143 million a year until the dissolution of the Redemption Fund for Inherited Liabilities. This corresponds to half of the annual annuity for these long-standing municipal credits.

In the financial year 1999, the Redemption Fund for Inherited Liabilities was integrated into the federal



budget, meaning that since then redemption and interest payments have been made in the context of the general debt service of the federal government (→*public debt*). This also means that the federal government provides the follow-up financing for payable liabilities. Further Federal Bank profits and the payments of the East German states are now exclusively used for the redemption of due liabilities (the so-called redemption contribution of the Fund).

Beyond that, the Fund receives further income, including revenue from the privatisation of housing enterprises, which is used to meet expenses in connection with the liquidation of foreign trade enterprises. Excess liquidity of the Fund is transferred to the federal budget.

By the end of 2003, the debts of the Redemption Fund for Inherited Liabilities amounted to about €33 billion, compared to the temporary peak level of debts without redemption of €181.4 billion. By means of the income from the 2002 auction of the Universal Mobile Telecommunications System licenses, an unplanned €34 billion was redeemed. The last planned liability of the Redemption Fund for Inherited Liabilities waits to be redeemed in 2011.

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## Resource protection

If the demand for a product exceeds the supply, the market solves this problem in the short term by pushing prices up; this in turn attracts additional supplies, and prices fall again in the long term. However, this does not apply to environmental goods, since the supply is finite and the price mechanism does not work in this case – which is sufficient justification for the call for a policy for the protection of natural resources.

But why do we have environmental problems at all? To answer this question from the environmental perspective one has to look to the competition for the utilisation of the environment, which has to function variously as a consumer product, supplier of raw materials and absorption medium for pollutants.

The exploitation of environmental resources is always accompanied by production and consumer processes, which inevitably bring unwanted by-products in their wake in the form of emissions or waste, followed also by emissions that are harmful for the environment. This is inevitable because, despite the theoretical interest in maximum production efficiency, a total transformation of inputs into outputs is simply not feasible.

The exploitation of the environment is thus an allocation problem of the environment as a natural resource in terms of its different conflicting roles. This has turned environmental exploitation into an economic problem, since today the environment has become a scarce resource, and scarce resources are valuable and have to be managed efficiently.

Why, however, should scarcity – from an economic perspective – cause problems where the environment is concerned, and why is the market not able to solve the environmental problems?

The reason is that environmental resources have very specific economic characteristics: they are not owned by anyone, since there are no property rights; they do not have a price – and anything free of charge tends to be over-exploited. But they are also exploited in a socially unregulated manner, or according to the law of the jungle, as it were.

Is the economy winning the battle for environmental exploitation today? The answer is not so simple: people are characterised by the variety of roles they play, which is why people in their different roles tend to clash (car driver versus nature lover). But there are also conflicts within the individual, and this means that no capitalist villains are required to take the blame for environmental problems; environmental emissions are the unwanted by-product of legitimate (because they are socially desired) activities. Why is this not only unpleasant, but a problem?

An economist would reply that the coordination of the individual agendas in a market economy is based on the principle that all economically relevant consequences are given a price, because a price signals scarcity. This is how, through prices, limited goods are channelled to the areas where they can be put to best use, which translates into maximum need satisfaction for all. Now, if no prices exist in certain areas (or if, mistakenly, the price is nil), maximum prosperity cannot result. A prod-

uct which cannot be sold at a certain price does not get produced and vice versa: if people cause others harm without having to make amends, they will have no reason to stop their actions (in quantity or composition). Thus, if actors are held only partly responsible for either the positive or the negative consequences of their actions, no optimum consumption or production will result; if the production manifests negative consequences, there have obviously been too many activities.

Precisely this applies to environmental goods: negative external effects of this sort cannot be added up and charged, because the exploitation of the environment has no price; and there are no prices because environmental goods do not belong to anybody. Even assuming that emitters with a high environmental awareness wanted to reduce their emissions voluntarily, they would constitute only a small number of the sources of emission and the effect would be negligible. This is the logic behind the collective attitude, and the state of the environment does not improve. The same would apply if individuals who have been harmed were to offer payments to the perpetrators for the purpose of reducing emissions. It would not be possible to prevent those who have paid nothing from benefiting from the improved quality of the environment. This is why it makes sense for everybody to wait and, if necessary, to catch a free ride, and this is precisely why nothing happens.

There is thus no such thing as an automatic campaign for the reversal of the deteriorating state of the environment, driven by individual people: in a world of self-interested people the

environment does not stand a chance. Is this correct? Would that not also mean that the economic regulatory principle, the  $\rightarrow$ market economy, has to be questioned? Are environmental problems a manifestation of market failure? Yes and No.

Markets can achieve optimal or satisfying results only if they receive the correct information input. But as long as the exploitation of the environment is free of charge, the message is that this commodity is in abundant supply, with the result that the environment becomes polluted. To prevent this, official intervention is required since the market, on account of the special characteristics of environmental goods, cannot send out these messages. This represents a challenge for the government and its policies.

But the government has done nothing for a long time – a classic case of policy failure. Instead of advocating the abolition of the market economy, they ought to feed it with the correct economic information and data, since this is precisely where the justification and the functions of an environmental policy must come from. Since only the government and government-authorized institutions are entitled to specify norms regarding the desirable quality of the environment, environmental policy is definitively a task that must be reserved for government (on the legal basis of Article 2 of the Basic Law, ‘the right to free personal expression and the right to life and freedom from bodily harm’, as well as the principle of the  $\rightarrow$ social state).

From an economic point of view, the political task should be the removal of the zero tariff for environmental

goods in order to put a stop to the misguided exploitation of natural resources. It should also entail penalising those who are causing negative external effects (internalisation). In principle, all this is undisputed – but differences of opinion exist in terms of the requirement level of environmental policy goals ( $\rightarrow$ environmental policy: conflicting aims), the determination of the most suitable policy-making authorities and the instruments that should be used for its implementation ( $\rightarrow$ environmental policy: actors and  $\rightarrow$ ...instruments).

Concerning the latter, economists are right to stress the criterion of system conformity with the market economy: we are in need of an environmental policy compatible with the principles of a market economy, which offers the incentives necessary for the prevention of  $\rightarrow$ environmental impact and harm, and which motivates people to search for environmentally friendly procedures and products. This must happen rationally and efficiently in order to ensure that the  $\rightarrow$ social market economy is at the same time also an ecological market economy.

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### Reunification: Monetary, economic and social union

An increasing movement was developing in the German Democratic Republic (GDR) in 1989 which led to political reunification between the GDR (East Germany) and the Federal Republic of Germany (FRG) (West Germany) on 3 October 1990. The precursor had been the monetary, economic and social union introduced on 1 July 1990, between two countries that were then still formally independent.

The monetary union was accomplished after less than five months, since Chancellor Kohl made the offer for the first time on 6 February 1990. This was the beginning of a process that played itself out with breathtaking speed, putting science, politics and administrative bodies to work around the clock, and producing results that are at least proof of the fact that all the institutions are in possession of a high degree of expert knowledge.

What happened on 1 July 1990? The GDR Mark was replaced by the Deutsche Mark (DM), the area where the DM was legal tender was officially extended by the GDR, and the →*German Federal Bank* accepted full responsibility for the monetary policy in the GDR. Constitutionally, until 3 October 1990 this monetary union was therefore a unique phenomenon in international law.

The economic union was established concurrently with the transfer of key elements of the →*economic order* of the FRG to the GDR. For example:

- assessment regulations for →*enterprises*;
  - conversion of wages at a parity rate of 1:1;
  - the economic area of the GDR became part of the domestic market of the FRG; and
  - Brussels agreed to expand the European Community to include the GDR without requiring it to join officially.
- The social union was achieved through a similar transfer – a procedure that likewise would have been inconceivable in any other way. In terms of the law of the FRG, all citizens of the GDR were at the same time also citizens of the FRG as soon as they moved to FRG territory – with all the obligations and entitlements entailed therein.
- The reunification occurred in three consecutive stages:
- economically on 1 July 1990;
  - politically through the incorporation of the GDR into the FRG on 3 October 1990; and
  - definitely with the first joint elections on 2 December 1990.
- At the heart of the economic reunification was the Treaty between the Federal Republic of Germany and the German Democratic Republic establishing a Monetary, Economic and Social Union of 18 May 1990 and the obligations of its implementation associated with it. From the point of view of institutional order policy, it is significant that this was the first time that the →*social market economy* was legally pro-

nounced as being the economic order of the Federal Republic.

A crucial issue for the economy was the question of which exchange rate should be used for the conversion of GDR Marks into DM. This decision was made more difficult by the fact that a market-related exchange rate did not exist between a market and a planned economy. Moreover, in this case the determination of the conversion rate was not a simple exchange rate decision but one which directly fixed all prices, → *incomes*, bank deposits, material property, the operational assessment of industrial plants, the assessment of rouble liabilities and many other things in DM; while at the same time every citizen, public administrative body and enterprise received a start-up provision in DM.

In a special report, the Federal Bank suggested a conversion rate of 2 East Marks to 1 Deutsche Mark. The federal government changed several points, finally agreeing on a rate of 1.81:1. Especially when it came to converting bank savings, the rate was improved on social grounds in favour of population groups whose members were unlikely to be able to partake in the profits and opportunities of the new economic environment. Owing to the high unemployment rate among the under-60s age group and the fact that pensioners in East and West Germany were given equal status, pensioners were clearly winners in the reunification. The conversion took place as follows:

- Wages, pensions and rental – 1:1.
- Corporate and personal borrowings – 2:1.

- Corporate and personal liabilities – 2:1.

Material assets depending on age:

- Born after 1 July 1976: 2,000 DM at 1:1.
- Born between 2 July 1931 and 1 July 1976: 4,000 DM at 1:1.
- Born before 2 July 1931: 6,000 DM at 1:1.
- All savings deposits beyond the limits and cash at 2:1.
- Claims submitted by private persons from outside the GDR at 3:1.

The calculation of the initial amount of central bank money which should be allocated to the GDR economy was equally problematical. Nobody could foresee how the GDR citizens would handle the cash, which made it difficult to determine the circulation speed of the money. Furthermore, there was uncertainty about whether the same methods should be used to determine the financial needs (potential-related) and whether it would be possible to determine the production potential (PP) correctly.

The PP reflects the greatest possible production capacity of a national economy. It is calculated on the basis of the different potentials (workforce, working hours, material capital, productivity), on the assumption that goods or services are produced competitively and for which buyers can be found in the market. There was no problem in assessing the workforce, but the materi-

al capital was outdated and difficult to evaluate, while the productivity was a matter of speculation since data on the performance potential of the GDR economy were contradictory. Above all, it was unclear how many products were competitive at all. For the PP, only marketable products count.

Assuming that the real potential (labour, capital) of the GDR economy amounted to 30% of the FRG economy, it follows that at a productivity level (FRG = 100)

- of 50%, the GDR has a PP of 15%; and
- of 30%, the GDR has a PP of 9%.

The extent to which the conversion rates were affected is illustrated in the table below. These uncertainties caused an over-supply of DM which, however, did not lead to inflation because the

GDR citizens were careful: there was no consumer intoxication and much of this money was saved.

But problems arose nevertheless because the conversion rate had the effect of a significant revaluation. To make matters worse, many GDR products were not competitive in the West, and due to the economic and political transformations the markets in the Eastern European countries were falling away. The number of collapsed businesses was growing and unemployment rose rapidly, meaning that initially more than two-thirds of all transfers from the West to the East were social transfers (→*solidarity surtax*, →*Redemption Fund for Inherited Liabilities*). The economic situation was made more difficult by a misguided wage policy. The objective of a rapid adjustment of the rates of pay did not take into account the development of productivity. The

<b>Conversion rates based on a non-inflationary DM supply for the GDR</b> in DM billions (1989)						
	<b>Actual values 1989</b>		<b>Non-inflationary money supply of the GDR</b>		<b>Conversion rates</b>	
	<i>GDR-Mark</i>	<i>DM</i>	<i>in DM</i>		<i>Mark against DM</i>	
			<i>A<sup>1</sup></i>	<i>B<sup>2</sup></i>	<i>A</i>	<i>B</i>
Central Bank money	17,5	146,9	19,5	14,7	0.9:1	1.2:1
M1 <sup>3</sup>	146,6	450,6	59,9	45,1	2.4:1	3.3:1
L <sup>4</sup>	252,0	2,738,3	364,2	273,8	0.7:1	2.0:1

1 Assumption: PP of the GDR = 13.3% of the PP of the FRG  
 2 Assumption: PP of the GDR = 10.0% of the PP of the FRG  
 3 Central Bank money plus domestic non-bank sight deposits with financial institutions  
 4 Sight-, term-, savings deposits, long-term bank deposits and other non-bank deposits with financial institutions

Sources: Deutsche Bundesbank, Monatsberichte; Jahresbericht der Staatsbank der DDR für 1989 .

Version of Table (Example line M1): Variant A: 13.3% of 450,6 = 59,9; 59,9 would be the non-inflationary supply; but the available money supply is 146,6; consequently a rate of 2.4 Mark: 1 DM should be adopted.

unit wage costs rose far beyond the level of FRG economy. This reduced competitive ability increased and entrenched unemployment and made enormous social transfers necessary ( $\rightarrow$ *Reconstruction East*), which put the social union under too much strain. As a result, more and more enterprises in the new federal states decided after 1995 to leave the wage agreements of the collective bargaining scheme and to negotiate rates of pay with the works councils in terms of what was economically possible ( $\rightarrow$ *collective agreements*).

A key element of the economic union was the dissolution of the collective combines of the GDR and their  $\rightarrow$ *privatisation* by the  $\rightarrow$ *Treuhandanstalt*.

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Rolf H. Hasse

### Reunification: Monetary union through currency conversion

Very soon after the Berlin Wall fell in November 1989, the people in the German Democratic Republic (GDR) demanded the introduction of the Deutsche Mark (DM) and the abolition of their own Mark. This was poignantly expressed in the slogan 'either the Deutsche Mark comes to us or we come to the Deutsche Mark'. This

prompted the decision by Federal Chancellor Helmut Kohl to establish – single-handedly – on 7 February 1990 a monetary union between the Federal Republic of Germany (FRG) (West Germany) and the GDR (East Germany) due to come into force on 1 July 1990, i.e. preceding the political unification of 3 October 1990.

This monetary union differs in crucial respects from the European Monetary Union, which came into force on 1 January 1999:

- Entering into a monetary union, the GDR and FRG were then two states with completely different  $\rightarrow$ *economic systems* and very disparate performance capacities. Above all, the GDR lacked banking and financial systems based on market principles. These had to be started from scratch immediately after the monetary union.
- Despite these enormous differences, no new currency (such as the euro) was created. Instead, the currency area of the more efficient FRG was simply expanded to include the GDR. This meant that the monetary union could therefore also be described as a currency conversion in the GDR.
- Since the introduction of the DM coincided with an abrupt transition to the  $\rightarrow$ *market economy*, it was not easy to find the correct conversion ratio. This, too, was different when the euro was introduced to the  $\rightarrow$ *European Union*. It is true that the DM and the GDR Mark had a political clearing rate of 1:1, but there was no foreign exchange market where an

exchange rate could form. The EU had long been involved in the intensive exchange of goods and a foreign exchange market, so that it was possible to apply the existing exchange rate relations to the conversion of the national currencies into the euro (→*European Economic and Monetary Union*).

Overall, one can say today that, technically, the German Monetary Union was a great success. The introduction of the DM as legal tender and the conversion of financial transactions went almost without a hitch.

From the economic point of view, however, the outcome was less positive. The conversion of the existing economic stock was straightforward (the cash stock and the financial claims and liabilities). Here the conversion was generally based on a rate of two GDR Marks to one DM; while a fixed personal amount of cash of 4,000 GDR Marks could be exchanged at the rate of 1:1. Although after the conversion the money supply in the GDR was about 50% higher than the level which had been recommended in a Federal Bank study, no inflationary impulses resulted for the area where the DM was legal tender because the largest part was saved and not spent.

The most difficult part of introducing the DM concerned the conversion of the economic flow aggregates, especially wages. For this purpose, exact estimations of productivity in the GDR would have been required, but this was hardly possible considering the general over-estimation of the efficiency of the GDR economy and the enormous economic transformation.

The main topic of discussion during the spring of 1990 was the question whether wages should be converted at the rate of 2:1 or 1:1. In the case of the former, after the monetary union, wages in the East would have amounted to a sixth of Western wages; in the latter case to approximately a third. It was not least due to political pressure that the 1:1 conversion was adopted.

Looking back, it is clear that the discussion at the time was far too focused on the conversion rate for wages, leaving aside the question of how the East wages would develop after conversion. Particularly worrying was the fact that even after July 1990 the East German enterprises were still predominantly without private owners, thus putting up little resistance against excessive wage demands. They were legally integrated into the →*Treuhandanstalt*, which was responsible for loss reconciliation but which despite its capacity as quasi-owner was never included in collective bargaining on the employers' side.

This soon led to wage agreements that were clearly aimed at the adjustment of Eastern wages to the Western level but that lay significantly above the productivity increase. Thus wage unit costs (→*business accountancy*) exceeded the level in the old states of the Federal Republic considerably, and these enterprises lost any chance of survival against international →*competition*.

While in the neighbouring transformation countries (Poland, Czech Republic, Hungary) the change of the industrial sector to market conditions went smoothly, only a few East German enterprises succeeded in adapting to market conditions, with the result that employment levels in the manufactur-



ing industries suffered a lasting and massive collapse.

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## Shadow economy

The economy of any country can be divided into two areas: the official (formal) economy and the shadow economy (unofficial, informal economy). The shadow economy covers all economic activities that represent a creation of value, but that are reflected neither in the macroeconomic balance sheet nor in the officially calculated national product ( $\rightarrow$ circular flow of incomes). Due to the shadow economy, therefore, the actual creation of economic value is always greater than it seems.

The unofficial creation of value of the shadow economy can again be divided into two areas:

- An area where the value creation simply cannot be calculated according to the criteria of the macroeconomic balance sheet.

- A creation of value which ought to be included but which, for different reasons (such as evasion), is not included.

The first area belongs to the so-called self-help economy, while the second area represents the so-called underground economy. Self-help activities include neighbourhood assistance, work around the house and garden, voluntary free cooperation in private relief organisations (such as the fire brigade and accident and emergency services) and private social work.

The activities in the underground economy include moonlighting, smuggling, misrepresentation of  $\rightarrow$ income and tax havens. This list already shows that self-help activities are predominantly legal whereas underground activities are illegal.

Over the past several decades the shadow economy in Germany and in nearly all the industrialised nations of the world has grown considerably. It is estimated that in Germany these represent between 15–20% of the officially calculated national product.

What are the reasons for a growing shadow economy? If the shadow economy is seen as an evasion economy, it makes sense that the agents of an economy escape from the formal into the shadow economy because it is obviously worthwhile for them. In so doing, they avoid paying taxes, social security contributions, administration fees and the national transfers of the formal economy. They have moved into the twilight zone that is largely exempt from taxes and contributions.

It follows that generally the shadow economy thrives and prospers more as

the tax burden and contributions in the regular economy increase. It is safe to say that a growing shadow economy is generally an indication that the bond of trust between citizens and the state is disturbed.

Thus, if the state wants to curb the shadow economy it would be unwise to go about this by imposing strict prohibitions, controls and punishments for activities in the shadow economy. Rather, the state should eliminate the reasons why people migrate to the shadow economy – the excessive costs (also in terms of time) of the formal economy caused by excessive taxes and contributions.

In the end, this would mean that the state reduces its demands on its citizens. As this happens, the citizens would be motivated to shift their shadow economic activities – at least partially – into the formal sphere. If this can make the shadow economy shrink the →*social market economy* will work more efficiently.

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Wolf Schäfer

## Social budget

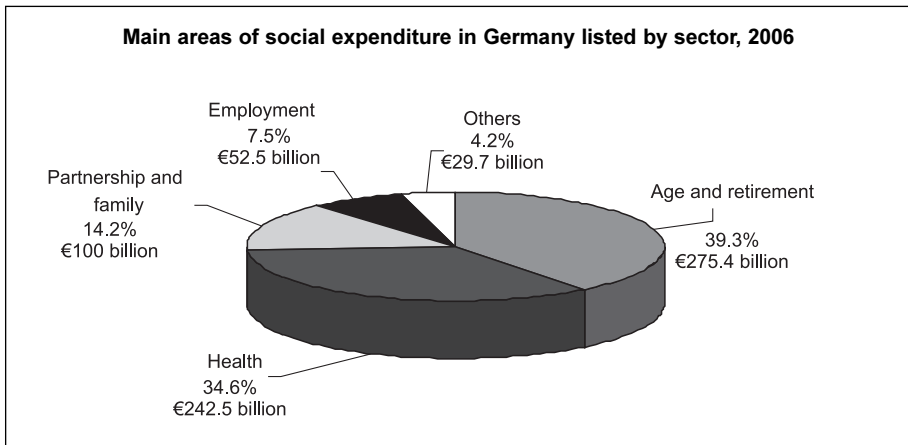
The social budget is a German federal government report which at certain intervals (usually once per parliamentary term) gives a detailed account of the social services rendered and the funding of all social security benefits. Frequently, this term is used to label the sum of all public social services of a time period.

The social budget divides all the services rendered in terms of institution and function, and their funding in terms of type and source. Institutions are social agencies subordinate to the regional government authorities (→*Federal Republic, federal states and municipalities*), or alternatively abstract institutions in charge of social services.

The social budget is divided into: general services (funding for →*pensions, →nursing care, →unemployment and →accident insurance*, job creation, child and educational benefits); special services (retirement funds for farmers, provident funds); service schemes of the public service; employers' services; compensation schemes; and social assistance and services. These services are collectively known as direct services.

Then there are the indirect services, which include tax measures such as the splitting of taxable income for spouses, and family expenditure compensation such as indirect benefits (child benefit or child allowances).

'Functions' are the various social facts (risks or needs) associated with potential claims to social services. Here, the social budget differentiates the following functions: marriage and family, health, →*employment*, age, surviving



dependants and other functions (such as housing, accumulation of wealth, the consequences of political events and general life assistance).

Funding methods include the social insurance contributions of the insured and the employers, the assignment of public means and other revenue such as capital returns, and settlements by the institutions among themselves.

Ever since the Federal Republic of Germany came into being, the social services have made enormous progress. Social security benefits have gone up in real terms from €32.6 billion (1960) to €700.2 billion (2001); in the same period, the per capita social security benefits have increased from €588 to €8,500 – or more than the rate of economic performance in Germany during the same period. As a result, the social security benefit ratio, which equals the proportion of social security benefits to the GDP, went up from 21.1% (1960) to 30.3% (2006).

The most significant increases to the social security benefit ratio were registered between 1965 (22.5%) and 1975 (31.6%) and again in the course of the German reunification between

1990 (27.8%) and 1996 (32.1%). From 1975 to 1989, the social security benefit ratio started to decline slightly.

The main areas of expenditure listed by sector are: pension insurance, which attracts the bulk of total social expenditure; health insurance; job creation schemes; employers' funds; and public service funds (*see figure*).

The most difficult problem of social reporting is the fact that the social budget does not accurately represent either the social services or the financial commitments of the private economic agents.

The social budget includes only the social services associated with transfer payments or shortfalls in tax revenues, which means that the government's social policy and policy regarding the institutional order are not reflected (these include protection against unfair dismissal, the right to *→co-determination* and the general regulations of the social rent law).

Moreover, the definition of services included in the social budget is made case-by-case, with the result that certain services covered by the social budget are not, according to generally accepted

fiscal principles, classified as social security benefits: examples are child allowances and the splitting of income for the taxation of spouses. On the other hand, services which clearly fall into the category of social services, such as those of the Federal Law on Education and Training Promotion, are not included.

Furthermore, the social budget does not differentiate between services intended as insurance benefits or as redistribution measures. Finally, the social budget reflects only the social services of the current period.

A large number of these social interventions merely lead to a temporary shifting of purchasing power, i.e. claims

to benefits arise today but have to be fulfilled only at a later stage. In order to obtain a comprehensive understanding of the flow of services and funds within the government's social policy, an inter-temporal calculation along the lines of generational accounting (= transmission of liabilities between the generations) would be required.

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Jörg Althammer

<b>German social budget, 1991–2006</b>				
in € million				
	<b>1991</b>	<b>2000</b>	<b>2006</b> <i>(estimated)</i>	<b>% change</b> <b>1991-2006</b>
Pension schemes	133,326	217,431	239,963	80
Health insurance scheme	92,674	132,044	146,830	58
Nursing care insurance	–	16,667	18,040	–
Accident insurance	7,640	10,835	11,181	46
Employment subsidies	44,599	64,767	83,242	87
Retirement subsidies for farmers	3,568	5,230	6,746	89
Pensions and grants for civil servants	34,513	49,063	49,829	44
Continued payment of wages, company				
Pensions	47,081	53,585	56,509	20
Social compensation, etc.	8,736	6,536	4,266	–51
Social grants	18,103	25,867	21,921	21
Youth subsidies	10,900	17,242	19,001	74
Children's allowance and family				
Tax-relief package	10,435	31,755	36,943	254
Child-raising allowance	3,232	3,732	3,055	–5
Educational grant	1,326	917	1,842	39
Accommodation grants	2,527	4,309	1,681	–33
Social tax benefits	27,948	40,077	36,404	30
<b>Total (nominal terms)</b>	<b>446,608</b>	<b>680,057</b>	<b>737,453</b>	<b>65</b>

Source: Federal Ministry of Labour and Social Affairs

## Social capital

Successful markets do not develop automatically. A  $\rightarrow$ market economy is a product of civilisation rather than a natural phenomenon. There are two reasons for this. The first is that a market economy requires a legal framework – an economic constitution with institutions and legal regulations (formal institutions/rules).

In addition, a market system depends on non-legal ties and rules of conduct between individuals which are based on trust and on which one can rely (informal institutions/habitual procedures).

One might imagine circumstances where breaches of contract and of confidence are the order of the day and where the norms of the economic constitution and of human conduct can be enforced only after the expenditure of large amounts of money and nervous energy (transaction costs). Without the weak ties, the strong ties of the law quickly become inadequate.

The concept of the  $\rightarrow$ social market economy has always emphasised the need for formal and informal ties. The ordonomic insight that market economies cannot be considered in an institutional vacuum relates to both these ties, and this explains the emphasis on the economic institutional order as a creative legislative accomplishment (Franz  $\rightarrow$ Böhm) that has to be shaped in detail according to the insights of institutional order theory.

Beyond that, the significance of historical ties (Alfred  $\rightarrow$ Müller-Armack) has been highlighted. These function only informally and are based on mutual personal agreement, but they are never-

theless indispensable in a market economy.

The concept of the social market economy thus takes into account the  $\rightarrow$ societal foundation of economic orders, which tend to be overlooked due to the sociological blindness (William  $\rightarrow$ Röpke) of economics ( $\rightarrow$ market mechanism,  $\rightarrow$ social market economy: concept of man). In this regard, it must not be forgotten that the fathers of the social market economy named their revised version of  $\rightarrow$ liberalism, ‘sociological neo-liberalism’.

More recently, the institutional framework of market economies has been examined in the light of  $\rightarrow$ institutional economics, which looks mainly at formal institutions of law. Informal institutions have more recently been considered in the context of a term that originally comes from sociology (and political science) – ‘social capital’.

From the economic point of view, the term social capital suggests that one is dealing with a factor of production ( $\rightarrow$ production and supply), such as the kind required for the creation of valuable products. One has to invest in this capital in order to develop capital stock for ongoing production, and re-investments are necessary in order to make up for the continual depreciation of the capital stock. However, this general description has not answered the following questions:

- How is the capital stock formed?
- What does the capital stock actually consist of?
- How should the ‘valuable’ products be defined?

The first two questions can be answered in two ways. On the one hand, the term social capital can be used to fill the gap between the individual and society, between the economic agents and the national economy. In this case, the value of relationship networks is paramount; these form the social glue that holds a society together. Social capital investments are possible only in the context of such networks.

Apart from this structural aspect, one can also ask what social capital consists of. Viewed from this angle, trust is the most important element. Here the crucial point is that trust develops in social networks but is not limited to its members. Social capital is universal trust, or the general expectation of all that they will not be exploited when engaging in cooperative relationships.

This also makes it possible to answer the third question. Social capital makes possible the realisation of the sorts of gains from cooperation that a free market economy is looking for. Anonymous relationships in the market, the division of labour and even trade relationships between strangers become possible thanks to universal trust – without having to consult the law books every time or having to write out voluminous contracts.

However, the effect of social capital is not restricted to the economic system. In terms of describing social capital through social networks, the importance of voluntary organisations for the pursuit of a great variety of common goals has to be stressed. Such voluntary organisations and the social capital they accumulate are regarded as a condition of a successful democratic system (civil society).

Due to its significance for a successful economic and political system, social capital plays an important role in developmental and transformational economics and also in the political agendas of →*international organisations*, particularly the World Bank.

Lastly, we therefore need to consider the economic policy conclusions that can be drawn from the ongoing debate on social capital: the economic policy of a free market system has to recognise that the policy cannot directly produce prosperity. An economic policy can create the conditions for prosperity only by providing the institutional framework. But on examining the concept of social capital more closely, one finds that some of these conditions cannot be produced directly by the state either. This in some way contradicts the optimism of some of the fathers of the social market economy who relied on their assumption that the right sort of social policy would co-create the necessary social glue.

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Stefan Okruch

### **Social justice (social balancing)**

Besides freedom, justice represents one of the highest basic values in socially

responsible and democratic social systems. Like all basic values, social justice is a superior social objective. Social justice as a moral value has a profound effect on the social life of humans and on their fundamental attitudes.

In the context of the →*social market economy*, basic values play two different roles. The first is associated with the fact that they are rooted in the shared cultural heritage of a society that includes the economy as an aspect (subsystem) of society (→*societal foundation of economic orders*).

Second, basic values are a part of the institutional order regulating economy. This was strongly emphasised by Alfred →*Müller-Armack*, but it was equally important to Alexander →*Rüstow* and William →*Röpke*, two of the major representatives of the social humanism movement. These founders of the social market economy postulated social justice manifested in private property for as many people as possible, and a humane way of life for every citizen. Their focus was the quality of human existence.

The special significance and worth of social justice is based on the acknowledgment of a specific concept of man. On the one hand, man is seen (in the tradition of Aristotle) as a social creature (*zoon politikon*), and, on the other (in deference to the principle of economic reason) is depicted as a self-interested, economically active individual eager to maximise utility.

Social justice is compatible with humane principles and the pursuit of the common good. According to these principles, all members of a society are supposed to benefit from the prosperity of the society, just as they are supposed

to participate in its creation, growth and preservation.

In terms of the social market economy, the practical performance of social justice should not be based on a one-sided understanding of justice, but must be aimed at achieving a balanced relationship between all the different kinds of justice. Any undesirable consequences for the society as a whole ought to be avoided. If social justice as a general principle is firmly rooted, the great variety of indicators for justice must be taken into account.

Contemporary ethics does not place the different criteria side by side, nor are they pitted against one another, but special emphasis is put on their mutual inter-penetration. Applied to the economy, the connection is made to the tripartite nature of the concept of justice as Aristotle and Thomas Aquinas defined it. Apart from the superior, general justice that focuses on the common good (*iustitia legalis*), the commutative justice or justice of exchange (*iustitia commutativa*) and the justice of distribution (*iustitia distributiva*) need to be mentioned.

It is worth noting that the different concepts of justice are not dealt with in isolation, but that their theoretical interpretation illustrates their mutual inter-connectedness. In economic ethics, concepts of justice which belong together are paired and placed opposite each other (*see box, next page*). In terms of content, these pairs partially overlap.

One of the fundamental postulates enshrined in the policy of a socially responsible market economy is the objective of a fair remuneration and property accumulation policy. In a market economy, fair exchange is a measure of just →*distribution*, which correlates

<b>Correlated types of justice</b>	
<b>Term</b>	<b>Correlated term</b>
<ul style="list-style-type: none"> <li>• Justice of Achievements</li> <li>• Justice of Opportunities</li> <li>• Reciprocal Justice</li> <li>• Justice of Exchange</li> <li>• Justice in Markets</li> </ul>	<ul style="list-style-type: none"> <li>• Justice of Needs</li> <li>• Justice of Outcome</li> <li>• Commutative Justice</li> <li>• Compensating Justice</li> <li>• Justice by Politics</li> </ul>

with the →*achievement principle*. Assuming that in a market, equivalent values are exchanged, neither of the parties to the exchange loses out and the coordination of activities in a market economy is fair. One of the positive effects of fairness is that it acts as an incentive to a continually improved performance. Justice of performance has to be complemented by justice of needs, since there are members of society who, due to their personal circumstances, do not perform successfully. In order for them to be able to enjoy a certain minimum standard of living, collective consensus must bring about the required redistribution of material means, rights and opportunities.

Apart from the consideration of the justice of needs, a degree of social balance is also necessary because justice of exchange in the markets is not always guaranteed, i.e. if prices do not really signal scarcity or if the achievement principle is not based on equal opportunities. The justice of performance (the option for the fittest) must be counter-balanced by the justice of compensation (the option for the weak), because lasting economic progress and growth cannot be achieved in the face of situations of drastic social imbalance. It can rather be reasonably expected that social balance will liberate economic forces. This means that social justice is supposed to

bring about social coherence. It is hoped that this can, on one hand, prevent great social contrasts and that, on the other hand, it will ensure social harmony (→*social iredics*) in the interest of economic prosperity.

Essentially, social balance is achieved through government redistribution policies. The necessary means for this are funded by →*public revenue*, which is in turn largely made up of the tax money provided by the society's top performers. Since this is the manner in which the state enforces solidarity by the strong with the weak, one has to make sure that the policies of social redistribution are sensitive, moderate and efficient, in order that they are not counter-productive. The demand for social justice will remain controversial as long as ideals of justice remain split, inconsistent and complex, and without a universal social consensus.

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*Friedrum Quaas*



## Social market economy: An introduction

Strictly speaking, the term social market economy refers to the economic concept which has formed the basis of the West German economic policy since 1948. In a broader sense, the term social market economy defines the *→economic policy* of the Federal Republic of Germany (FRG) in respect of form and content.

In the process of German *→reunification*, the Treaty between the Federal Republic of Germany and the German Democratic Republic establishing a Monetary, Economic and Social Union, of 8 May 1990, formally declared the social market economy the common economic order of both contracting parties. Its content describes the economic order behind the social market economy as characterised by the specific features ‘private property, competition, free price formation and generally total freedom of movement in terms of work, capital and services’ (Article 1(3) of the treaty of reunification). The social order that best complements the social market economy is characterised by ‘a labour market order which is compatible with the social market economy and a comprehensive system of social security services based on the principles of justice of achievement and social compensation [balancing]’ (Article 1(4)).

This legal definition of a *→market economy* based on social principles, which also serves as a basic model of society, remains profoundly influenced by the views of Alfred *→Müller-Armack*. In his 1946 book on economic administration and market economy, Müller-Armack

not only introduced the term social market economy into the public debate but also made a significant contribution towards the creation of the associated theoretical concept by representing the idea of the social market economy in contradistinction to the centrally controlled economy of national socialism, and also contrasting it with all other familiar *→types of market economy*.

Apart from Müller-Armack, it is above all the representatives of the Freiburg school who paved the way for the social market economy, especially Walter *→Eucken*, Leonhard *→Miksch* and Franz *→Böhm* as well as Wilhelm *→Röpke* and Alexander *→Rüstow* as representatives of economic and social humanism, as it was then called. The intellectual resistance to the national socialist system by the Freiburg circle (Erwin von *→Beckerath*, Constantin von *→Dietze*) and the Kreisau circle resulted in important preliminary thoughts on the structure of post-war Germany. Here, people of extremely different world views, background and education came together to engage in dialogue. It was Ludwig *→Erhard*, who, having been instrumental in the outcome of the economic and monetary reforms of 1948, went on to tackle the practical economic implementation of the concept of a socially orientated economy, only to take it further when he became Minister of Economic Affairs and, later, Federal Chancellor. Erhard is generally hailed by the public as the great practitioner and father of the social market economy.

For Müller-Armack, the economic concept of the social market economy was open and had to do with a certain style rather than a closed theory. This

ensures that necessary adjustments of the concept to changing social conditions are definitely possible. Secondly, it has become obvious that the dynamics of the economic style of the social market economy virtually make openness to social change a necessity. Yet conceptual adjustments and variations have to be introduced in such a way that the basic idea of the concept is not harmed and does not lose its meaning. Müller-Armack expressed this basic idea of the concept of the social market economy in an abstract, generalised and abbreviated formula. During political transformation, the content of this formula has to be translated into practice under consideration of the prevailing social conditions ( $\rightarrow$ *social market economy: political implementation*).

According to Müller-Armack, the 'point of the social market economy' is 'to combine the principle of a free market with that of social balancing'. This formula makes it possible to estimate to what extent theoretical progress and practical policy results are still compatible with the original concept of the social market economy. The idealised concept of human liberty that is complemented by  $\rightarrow$ *social justice* serves as the frame of reference. The theoretical and historical sources of the social market economy therefore include both society-oriented theories of  $\rightarrow$ *liberalism* with their underlying idea of freedom, as well as ethically orientated social philosophies which provide a basic understanding of social justice.

In this interpretation of the social market economy, the basic social values of liberty and justice represent two sides of a relationship whose tension has to be maintained and tolerated. It is clear-

ly important not to put too much strain on one side while neglecting the other. Secondly, a social market economy cannot be interpreted as a mere compromise between liberty and social justice, with one of them continually having the upper hand. Rather, both values stand in a complementary relationship to each other. Liberty and justice are frequently portrayed as conflicting values that can be resolved in a manner which Müller-Armack referred to as dialectic.

If we accept that freedom and justice include security and human dignity, then the concept of the social market economy has an integrating force capable of combining the different world views in the spirit of the conciliatory movement of  $\rightarrow$ *social irenics*. This makes the concept of the social market economy potentially appropriate for an international economic system – for example as the  $\rightarrow$ *social market economy in the EU*.

Looking at the practical results of the social market economy in Germany over time, different phases can be distinguished which are characterised by the degree of their compatibility with the theoretical model. Müller-Armack himself already mentioned a second phase of the social market economy, when in 1960 in the course of a critical examination of what had been achieved, he suggested that the social market economy should be complemented by a new society-oriented policy model bearing in mind the principles of economic systems emanating from society generally, and from the social market economy in particular.

At present, the following timeline has found acceptance in the literature.

After the initial difficulties had been overcome, the first phase (1948–1966) was characterised by the initially extremely successful realisation of the principles and style elements of the social market economy. The so-called economic miracle of the 1950s, which led to the fundamental technological modernisation of the production processes and the rapidly rising standard of living of the population of West Germany, are considered as proof for this. The American support in the form of the Marshall Plan was helpful in this development, as were:

- the availability of a large potential workforce for the full utilisation of the production capacities;
- the absence of any particular setbacks in terms of business cycles; and
- a stable domestic situation.

Starting in 1957, a gradual ‘style-decay’ set in, which manifested in a slow-down of economic →*growth*, →*conflicting aims in economic policy*, disputes regarding distribution and a gradual hardening of the social climate. The second phase (1967–1978) was dominated by a policy of demand management along the lines of →*Keynesianism* and →*interventionism*. This entailed increasing restrictions of free markets and the violation of market principles in the rooting principle of economic liberty, as well as in the criterion demanding the market conformity of economic policy measures by the state. The third phase (1979–1989 or 1990) started off with the failure of the policy of demand management. It is true that subsequent

to the change in government in 1982, the economic policy became more focused on the stimulation of market processes, but on the whole this phase was characterised by stagnation in terms of →*institutional order policy* and the consequent backlog of reforms.

The reunification of the two German states marked the beginning of the fourth phase (since 1990). The institutional reforms of economic order deemed necessary have increasingly been supplemented by demands for a changed →*welfare state* and for a changed →*social policy*. One of the priorities here is the re-establishment of a balance between the economic and the social dimension. These positions prevail in the current theoretical discussion on this topic. They demand a return both to the roots and to the renewal of the social market economy.

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### **Social market economy: Concept of man**

The concept of man is today both a cause for conflicting personal opinions and a hotly contested political debate.

The concept of man is the benchmark for the expansion of any form of human existence on earth; without it, a judgment on the worst excesses of contempt for human beings – such as those perpetrated by certain 20th century ideologies – would be impossible.

Communism divided people and society into classes depending on value judgments. The Soviet Union (from 1917) and its satellite states (including the German Democratic Republic [GDR] between 1949 and 1989) sacrificed millions of human lives and entire families to this belief.

For national socialism, race had more importance than man; this delusion prompted the persecution of whole peoples, especially the Jewish people, even to physical destruction. But the national socialist ideology did not even respect the members of its own people ('you are nothing, your people is everything') with the consequence that the basis of existence of a large proportion of the German people was wiped out in the Second World War.

Both ideologies had their own definitions of 'life unfit for life', and as a result felt authorised to destroy it. Both caused the largest refugee movements and crimes of expulsion in the history of mankind, at the same time causing the most devastating cultural losses in Europe ever.

Subsequent to this devastating catastrophe, the United Nations Universal Declaration of Human Rights (1948) was the attempt by the international community to take a stance. And since the establishment of the International Criminal Tribunal in The Hague, set up in response to war-relat-

ed crimes and the expulsion of people from their countries in the Balkans, human rights violations have become punishable crimes that can be prosecuted anywhere in the world. This has made international law much more effective, and is an encouraging indication of the growing solidarity between people for the protection of basic human rights, even including illegitimate regimes and dictatorships.

After the Second World War, 'with responsibility before God', the German people gave themselves a new national, political and social order in the form of the Basic Law. Article 1 solemnly declares that human dignity is inviolable. Having learned from the wrongs of an ideology which elevated one man over another, with all the terrible consequences that had occurred during the Nazi period, the conviction that the dignity of every man is sacrosanct (independent of race, religion, sex or disability) since any violation of this principle leads to barbarity, was enshrined in the constitution. Looked at from that perspective, there is no 'life unfit for life' and every human being is under the protection of the state. In terms of Article 79(3), the fundamental rights according to Articles 1-20 of the Basic Law are unalterable.

On the basis of the natural law, the American Declaration of Independence (1776) had already stressed that human beings are given dignity and rights 'by their creator', together with the human nature created by God, as it were. This view rests on the story of creation in the Bible, in Genesis 1.27. It says: 'God created man in His own image; in His own image He created him; as man and woman he created them.'

No matter whether the biblical concept of the God-likeness of man is adhered to or whether one subscribes to a humanist concept of man (natural law), human dignity means that 'man is more than he knows about himself.' (Ernst Benda). This imposes limitations that are not eliminated by the fact that the perfection of human dignity shows a contrast with the imperfection of the earthly human state of existence. No human being can overcome this dialectical relationship; they have to put up with it. Today, this is particularly relevant regarding scientific research and its application to human beings in the areas of bio and genetic engineering, as well as at the existential extremes of man at the beginning and end of his life.

Another facet of the respect for human dignity is that man must be accepted as he is. Only on this basis can he be free and can he be held responsible for his actions. He who wants to save human beings from their imperfections by trying to change them according to external criteria, or by prescribing their mission in life, robs them of the natural gifts of freedom and responsibility, makes them dependent and immature, and robs them of their deepest life motivations. But he who accepts others as they are will find that everybody is different. Inequality is a human constant. It enriches human life; only ideologues are bothered by it. Two examples can prove this.

- Human beings have different gifts and abilities and they also do not have them to the same degree. This is why the same or a comparable effort will not yield the same result. This applies

as much in education and training as in the economy and working life. Representatives of a collectivist or socialist view of man deduce from these findings that it is their ethical duty to provide more equality. This is a legitimate political request, as long as there is consensus that there can never be complete equality and as long as the effort to bring about equality does not cross the line beyond which this turns into coercion and the violation of human dignity.

- Human beings have different interests, ideas and opinions. This has the consequence that they pursue different goals in different ways and that, above all, they interpret the meaning of life very differently. Identical or comparable life situations are therefore often assessed by different standards, whereas different situations are frequently judged equally, if one uses subjective satisfaction, hope or happiness as yardsticks. Representatives of an individualist, utilitarian (aligned along pure utility) or hedonistic (personal attainment of pleasure) concept of man often derive their demands for personal happiness from this. This is permissible as long as the social responsibility for one's fellow men is also sufficiently accepted. Otherwise, unrestricted liberty can mean coercion and the violation of human dignity for others.

These examples show that one-sided concepts of man can cause problems and can even lead to dangerous situations. For this reason, the equally personal and socially orientated concept of man, which is compatible with the

Christian and also with the secular humanist tradition, is the best way of drawing up responsible policies and avoiding mistakes. However, these examples also clarify the limitations of any policy of social equality.

What is the most universally acceptable interpretation of →*social justice* as a social policy goal? It is respecting human dignity as it is enshrined in the Basic Law?

'Factual constraints' are often brought up in this debate. One talks about mechanisms (price mechanism), automation (= job losses) and inevitability (such as resulting from →*globalisation*), which one needs to follow or which one must follow without exposing oneself to the necessity of an ethical and consequently also a political decision.

The above-mentioned factual or practical constraints are a mistake or at best a propaganda trick in the daily political battle. Only nature has its own autonomous laws; these are laws we have to obey if we do not want to fail. 'Autonomous laws' in the economy, society and in politics never work only objectively, dealing with specific issues, 'but they also have a subjective side where they affect the emotions and direct the will' (Helmut →*Thielicke*).

This means that the goal of social justice has to be intimately linked to an objective based on human dignity and the constitutional concept of man. This goal is only realistic as a result of the complex interactions of human beings in the context of an institutional order in constant need of improvement. Achieving this goal through human intervention is possible only indirectly and to a very limited extent.

Factors of crucial importance to man and his actions are the legal and the political order and the order of the economy and society (→*social market economy*). In their own right, these contribute to the development and protection of the concept of man. At the same time, it becomes obvious how important it is that these social sub-systems are compatible with one another and complement one another (interdependence of institutional orders).

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### Social market economy: In the EU

On 1 January 2002 the euro was introduced in the form of notes and coins in 12 of the member countries of the European Union (EU). This was a historic event: for the first time in 1,500 years, the same coins are accepted from the Mediterranean to the Baltic Sea.

Within Europe, the development towards the European currency took place gradually. The conclusion of the Treaty of Rome (1957) first saw the creation of a customs union with a common customs tariff, followed by the single European market, characterised by the removal of the border controls between the member countries. Now a common European home market is emerging with a common

currency and a European Central Bank. This is probably the most powerful form of economic →*integration* of sovereign states in economic history (→*European Economic and Monetary Union*). At the same time, we are going through an accelerated process of →*globalisation* and making strides towards a knowledge society, which is becoming a reality through new forms of communication and information.

Europeans are now facing the task of having to formulate common economic policy principles for the member countries of the monetary union. Each country has very different traditions. There is, for example, the French system, which has strong elements of a centrally managed economy. Then there is the Anglo-American version of the →*market economy*, which was put into effect by Margaret Thatcher in England almost to perfection. Finally, there is the German tradition of the social market economy of Ludwig →*Erhard*, which is based on the model of Walter →*Eucken* and Alfred →*Müller-Armack* with a specific institutional order. The dissemination of these ideas was made especially difficult by the fact that their books have hardly been published in other languages.

The European Parliament made efforts early on to secure expert advice. The establishment of the Brussels initiative did just that (1994). It comprised a group of professors, business people and politicians, who made it their aim to work out a suitable economic policy for the EU. Their fundamental ideas are contained in the Prague Declaration of the →*social market economy* (2000). Then there was an initiative by German and Polish bishops, who in the Kütz

Declaration demanded that the concept of the social market economy ought to be made the model for economic policies and be enshrined in the Union Agreement as such.

Once a year, the European Parliament convenes in order to discuss economic policy guidelines. Following the statement by the European Parliament, these are then adopted in June, on the recommendation by the EU Commission and the Council (→*EU: organs and institutions*). This prompted the submission of the Wogau report (2001), which demands that the social market economy should become the economic policy model for the EU. The declared principles of the social market economy are freedom and democracy, →*competition*, monetary stability, the subsidiarity principle, private property and solidarity.

In his book *Capitalisme contre Capitalisme*, Michel Albert describes the economic system of Germany which tends to be associated with the social market economy as 'Rhineland capitalism'. This is a definite misunderstanding. The central control mechanism of a market economy is not capital, but the market. Furthermore, a coherent regulatory framework regarding social, environmental and competition-related issues is required.

Then there is also the school of thought that condemns markets and competition outright. In this view, the market needs a social rescue service to salvage the victims of this 'evil' competition. The ongoing discussion in the European Parliament is intended to lead to the insight that the market itself is, provided it plays by clearly defined rules, capable of producing social results.

A prominent principle of the social market economy is competition. There is an ongoing debate in the institutions in Brussels on the relationship between competition in free and open markets and the idea of the state, the municipality and free social welfare organisations as providers. If the market is just as capable of providing for the people as the alternatives that have been mentioned, it should be given a chance.

Competition in free and open markets was also the basis of the economic system of Ludwig →*Erhard*. However, during his terms as Minister of Economic Affairs and Federal Chancellor, the telecommunication, power and transport monopolies in Germany remained in place. But it was Erhard who incorporated the fundamental regulatory framework for competition in the respective Articles of the Treaty of Rome. His agreement to the Treaty was conditional upon its acceptance.

Meanwhile, one might say that Erhard's ideas are being re-imported from the EU to Germany. The removal of the telecommunications monopoly in Germany was possible thanks to EU regulations. The great danger here is the potential replacement of public monopolies by private monopolies. In this case, the state would have pocketed one-off profits through the sales of its enterprises, but without securing the benefits of competition for its citizens.

In the course of the preparation of the Treaty of Maastricht, price stability and its significance were under constant discussion. Among the Green parties, the Socialists and the Social Democrats the opinion prevailed that the Central Bank, concurrently with price stability, should also be promoting the goals of

→*growth* and →*employment*. By contrast, the majority of the members of the Peoples' Party and the Liberals felt that price stability must be the primary goal. In their view, the Central Bank should pursue the other goals that have been mentioned only if price stability is not put at risk.

There are two reasons for this strong emphasis on →*price level stability*. The first is that inflation has the greatest impact on people who have to live on small, fixed →*incomes*. They have no way of evading the effect of inflation. For them, inflation is nothing but cold expropriation.

The pursuit of price stability is therefore the first step towards a successful →*social policy*. Secondly, inflation has a bad effect on investments. The control signals of the market are distorted. This makes price stability one of the basic conditions for a healthy market economy.

The subsidiarity principle, which has by now also been incorporated into the EU Treaty, must find application both in the public sector and in the economic policy. The economy is familiar with this principle since over the past several decades nearly all large enterprises have been decentralised, while the internal structures were divided into manageable areas of responsibility.

In the sphere of economic policy, the application of this principle must have the effect of competences and responsibilities being clearly assigned to the different policy levels. This process will make it necessary to turn the Community from its head on to its feet. Due to the specific nature of its historical development, the European Community was driven too far towards cen-



tralism in certain areas while the capacity for joint action was insufficient.

The establishment of common external borders and the opening up of internal borders, the dismantling of trade barriers between the EU member countries and the introduction of a common currency have all stimulated competition between enterprises to the advantage of the consumer, while at the same time making them more competitive internationally. However, competition between enterprises is not the only issue at stake. The member countries and their regions automatically start to compete with one another on who can offer their citizens the most efficient public service supply on the most favourable terms (→*systems competition*).

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*Karl von Wogau*

### **Social market economy: Political implementation**

The monetary and economic reforms of 20 June 1948 mark the birth of the →*social market economy* in West Germany. It was the beginning of a social and economic institutional order, which after a short time was admired as the economic miracle everywhere in the world.

It was Ludwig →*Erhard* who suddenly, arbitrarily and against much opposition from all quarters of society,

linked the economic reform with the currency reform and simultaneously led the new currency, the Deutsche Mark, to success.

Some time after the economic reform, the social market economy was put to the test for the first time. On 12 November 1948 the trade unions called a 24-hour general strike in which nearly 10 million employees in the Bizone (parts of Germany under British and United States occupation) participated. They were protesting not only against price increases but against Erhard's policies in general. At the same time, the Social Democratic Party (SPD) parliamentary group in the economic assembly demanded Erhard's resignation. 'The actual result of your policies is that you drive people to despair by what you call freedom', wrote Erwin Schoettle in his explanation of the motion put forward by the SPD. But the general strike and the motion did not succeed. One reason was that, as Erhard had predicted, the price development started to stabilise at the end of 1948.

In 1949, the Basic Law gave the Federal Republic of Germany a constitutional framework which did not mention a specific economic system; but the Articles of this law did envisage a democratic and free market system. Over time, the country was also able to achieve:

- freedom of contract and association;
- the guarantee of private property;
- a state with a federal structure;
- social security;
- worker participation;
- the central bank law;
- competition laws;

- the gradual liberalisation of foreign trade; and
- full currency convertibility.

At the first election to the German *Bundestag* (parliament) on 14 August 1949, when Konrad Adenauer became the first Federal Chancellor and Erhard was appointed Minister of Economic Affairs, the political decision regarding the social market economy won by a hair's breadth. During the election campaign, the SPD had been demanding state planning and controlled production (→*socialism/planned economy*), including the socialisation of large and primary industries, financial institutions, banks and insurance companies. Certain factions of the Christian Democratic Union (CDU) were flirting with the socialisation of at least partial sectors of the economy (primary industries), as in the Ahlen programme (1947). The Free Democratic Party (FDP) opposed these moves from the outset and supported Erhard's political-economic concept during the crucial phase of 1948 when Erhard was director of Economic Administration of the United Economic Area in Frankfurt, and working on currency reform by decontrolling prices.

During the early 1950s it was mainly the labour market that was causing problems. The number of unemployed had risen from 800,000 in the late-1940s to 1.5 million in January 1950. Again, many blamed this development on the social market economy. The Allied forces also criticised the apparent inactivity of the German government and demanded a fundamental change in economic policy along the lines of →*Keynesianism* and Keynes's ideas on

full employment. This contradicted Erhard's convictions. He saw the economic situation as a consequence of insufficient investment capital and called for the promotion of capital formation and private investment activities, which would create jobs in the long term.

In the early years, the social market economy was in a critical phase. Adenauer was not sure whether the economic policy direction his Minister of Economic Affairs was following should be pursued further. In order to form an opinion, Federal Chancellor Adenauer gave instructions at the beginning of 1950 that a scientific report should be drawn up as the basis for independent proposals for a German economic policy. Wilhelm →*Röpke* was entrusted with this task; Röpke's general philosophical outlook reassured Adenauer, and the international reputation of the scholar was beyond question. In the report, 'Is the German economic policy correct?', Röpke showed that there was no alternative to Erhard's chosen path. Röpke's report supported Erhard and prevented a change of direction towards central planning and control.

In 1951 Erhard and his →*social market economy* came under attack once again. As a result of the Korean war, the Allied forces demanded a government-managed economy as well as price and exchange controls. Erhard resisted the 'planned economy temptation' and immense political pressure from inside Germany and made only a few concessions. This time, too, he consistently and persistently stuck to his position. The rapid economic recovery during the 1950s confirmed that Erhard was

right, and economic success was there for all to see.

The economic development in West Germany up to the mid-1960s was characterised by high growth and stable prices. →*Unemployment* went down gradually, and towards the end of the 1950s full employment had been achieved; workers even had to be recruited from abroad. ‘Made in Germany’ became a brand for quality, which was recognised worldwide. Erhard rejected the concept of the economic miracle, which was becoming popular, by asserting that the development was not a miracle but ‘only the consequence of the honest effort of a whole people who had been given a second chance to live in freedom and to utilise human initiative, human liberty and human creative energy’.

The social market economy was unleashing creative forces in people because it provided a platform for the free development of the individual through competitive performance and →*individual responsibility*, embedded in a regulatory framework; social balancing secured a decent life for the needy (→*social justice*).

The social aspect of the system was never seen as a way of partially realising the sort of goals which →*socialism* was demanding and promising; rather, it was regarded as a necessary regulatory mechanism to curb the excesses and erroneous trends of unfettered market forces. This was supposed to be an integral part of the free market system and intended for its own good.

Apart from Erhard’s palpable success as Minister of Economic Affairs, it was above all respect for the professional competence of the ‘fat guy with the

cigar’ that made him popular. It is therefore hardly surprising that everyone was looking to him for new momentum after Adenauer’s term of office. It was commonly thought that with courage, confidence and optimism, Erhard would be able to overcome the stagnation which was threatening political life in West Germany. On 16 October 1963 he was elected Federal Chancellor by a large majority in the German *Bundestag*.

The first economic slump of 1966–1967 – ‘slump’ referring to an economic growth of ‘only’ just under 2% in 1966, a clear slow-down compared to previous years – was the cause of widespread pessimism during the 1960s. Calls for more public commitment and excessive wage demands undermined Erhard’s cautiously moderate policies. His appeals to stop over-taxing the available resources fell on deaf ears.

The appreciation of the need to reconcile what is necessary with what is desirable was disappearing. Voters increasingly lost faith in Erhard’s concepts. When during the consultations for the 1967 Federal budget he clearly advocated tax increases as opposed to an increase in →*public debt* to finance a looming budgetary deficit equivalent to approximately €5 billion, his coalition government collapsed. But Erhard anticipated his fall, and on 30 November 1966 he resigned as Federal Chancellor.

The hour of the Social Democrats and in particular of Karl →*Schiller* had arrived. As long ago as the late 1950s, through its Godesberg programme, the SPD had openly declared itself in support of a free market system. And yet

there was a paradigm shift in economic policy. The concept of the free market was married with the Keynesian idea of demand management. By manipulating demand, the state wanted to stimulate economic growth. A →*concerted action* with the participation of the state, business federations, trade unions and the →*German Federal Bank* was expected to stabilise business cycles. Through the new model of an 'enlightened economy', Schiller initially managed to resuscitate the ailing economy. The economic cycle seemed to have become controllable, and there was a conviction that economic development was feasible (→*constructivism*).

However, the decision-making capacity of the government was eventually not able to cope with these policies. The interpretation of the concept was too one-sided (expansive measures during recession, the lack of timely restraints during times of excessive expansion). This led to the expansion of the public sector while the collective responsibility for economic policy decisions was gaining ground. Particularly during the very difficult phase following the oil crisis and the 1973 collapse of the Bretton Woods monetary system (→*currency system and exchange rate regimes*), the 'new economic policy' proved to be a political-economic mistake.

Very high wage demands placed an additional strain on the economy. The profit situation for businesses was worsening dramatically. Furthermore, foreign trade problems were causing monetary disturbances. The impetuous reform policies of the Social-Liberal government boosted the trend towards a →*social welfare state*. The rule that one

can spend only what has first been earned was forgotten.

Government authorities were getting deeper into debt. The state ratio (the proportion of public expenditure in the gross domestic product) of 30% during the 1960s rose to over 50% by the end of the 1970s. Nothing shows more clearly that the principles of the social market economy had been abandoned at that time: a state ratio of 50% means that half of the economy is market economy and the other half central planning.

With the continually increasing problems of this new economic policy came the realisation that a change was necessary – a turn-around that would reinstate the principles of the social market economy as the compass for economic policy. The political conflict over how to consolidate the budget and how to achieve a reduction of the state ratio, compounded by arguments on foreign affairs and security issues, finally led to a change of government in October 1982. The new government placed an increased political focus on the concept of the market economy. The reduction of the national debt, massive tax reductions, the first beginnings of →*deregulation* and →*privatisation* gave the economy new momentum.

It was soon possible to regain political-economic confidence and internal stability, and as the state ratio, the budget deficit, new debts and inflation could be reduced, the economy began to grow. It was the time when the economic policy followed the motto of supply-orientated policy. Deregulation, getting rid of red tape, liberalisation and a focus on world markets were the guiding principles of the new policy.

Looked at in detail, this policy was not true to the social market economy in the spirit of Erhard, who felt that politics should not exclusively or primarily have to serve the economy while the economy is allowed to act as if it were an end in itself. The economy has to serve the consumer. A flourishing economy is only meaningful if it creates prosperity for all. This has to be based on a consistent legal framework which prepares the ground for a competitive economy and the development of appropriate social conditions.

The economic recovery of the 1980s, the consolidation of the public finances as well as the tax reform created stable conditions for both the domestic economy and external trade. It formed the economic basis of the German →*reunification* in that it made the large West-East transfers possible in the future (→*Redemption Fund for Inherited Liabilities*).

The effort to revitalise the social market economy in the long term slackened off during the 1990s. The new challenges of the German reunification and the huge financial burden during the economic and social integration of East Germany played an important role in this (→*reunification: monetary, economic and social union*). The triumph of modern technology, the trend towards the service society and the →*globalisation* and Europeanisation of the markets remorselessly exposed the weaknesses of 'location D' (Germany). This was reflected in high unemployment, rising national debt and an expanding social security system. Besides, the government was unable to convince the population of the necessity for comprehensive reforms; this also accounts for the

election defeat in September 1998 of the government of Helmut Kohl, a coalition made up of the Christian Democratic Union/Christian Social Union (CDU/CSU) and the Free Democratic Party (FDP).

After the Christian-Liberal coalition had been in power for 16 years, it was replaced by a Red-Green (Social Democratic Party-Green Party) government in November 1998. In 2005 a coalition of the Christian Democratic parties (CDU/CSU) and the Social Democratic Party (SPD) took over, led by Angela Merkel (CDU).

Urgent pressure for reforms and an overdue restructuring of the social market economy continue to be on the agenda. Revitalisation is necessary partly because the mistakes of the past must be corrected, but also, and most importantly, because of the profound and rapid economic and social changes due to globalisation, technological advances and →*demographic development*. Indeed, the framework of the market economy needs adjustments in many areas. Flexibility, innovation and adaptability must be reinforced, and room for creativity has to be provided to act as a performance incentive. Globalisation and the information society are not about usurping the social market economy with unfettered global capitalism; these must, rather, be vigorously adapted to the new conditions. A new model of personal responsibility and independence is required:

- Most importantly, the state has to concentrate on its functions.
- For the revitalisation of the social market economy, a simple, transpar-

ent taxation system with low tax rates is necessary, as well as a marked reduction of the state ratio and the definition of the federal system as 'competitive federalism' (→*fiscal federalism*).

- A further necessary element is an →*employment* and wage policy committed to employment creation: only those earning an income can expect to have independent control over their lives. At the same time, a lasting reduction of →*unemployment* frees government capacities and helps the consolidation of the budget.
- Tariff reforms have to strengthen the autonomy of single enterprises in the context of industry-wide collective agreements, enforce moderate wage policies associated with modern worker participation, and generally introduce more flexible elements (→*labour market order*).
- In the social security sector – particularly in the areas of pensions and health – the balance between solidarity and subsidiarity has to be redressed and made fair and reliable for every age group. More personal responsibility means that the demographic development has an impact on how pensions are calculated. But on the other hand it has to be made clear to the younger generation that they have to work harder than their parents and grandparents for their retirement and health insurance (→*social system*; →*social state, welfare state*).
- In view of the increasing internationalisation, the regained competitive

ability of the German economy must be appropriately protected. To this end, a European and international competition policy – for example, in the context of the World Trade Organization – must be agreed and must become legally binding for all enterprises operating in the world market.

The social market economy was developed both as a liberal alternative to the planned economy and as a social alternative to the pure market economy. It has made a major contribution to prosperity, social harmony and political stability. The basic elements of the social market economy remain valid also in the future. Its detailed form must be adapted to the new challenges. This is the only way for lasting growth, for a dynamic labour market to develop and for the economy as a whole to be modernised in a socially acceptable manner, while getting ready to take on global competition.

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## Social market economy: Principles and functioning

The term social market economy is closely associated with the institutional order of German economy. The underlying concept became internationally respected on account of the economic miracle, which is what many people called the economic development in Germany during the years after the Second World War. Many developing countries and also Central European states use this model, which was attractive enough to help put an end to the division of Germany in 1989.

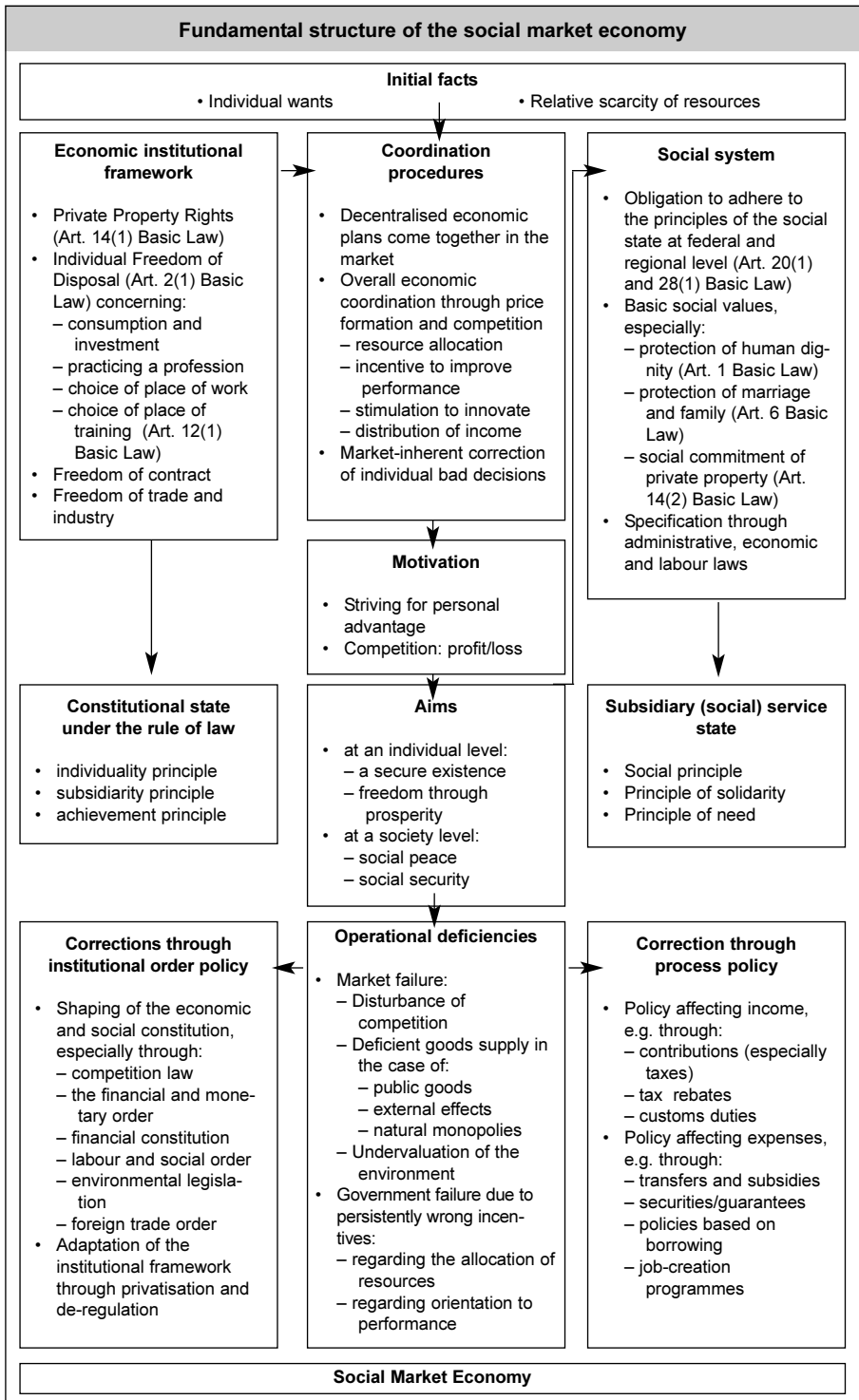
Since flexibility and adjustment are important characteristics of the social market economy, there cannot be a firm definition of its political organisation. When the fathers of the social market economy were drafting this institutional order, they avoided a too detailed outline. The relevant objective was above all to connect 'the principle of a free market with that of social balancing' (Alfred →Müller-Armack) in order to create and secure 'prosperity for all' (Ludwig →Erhard). Therefore, Müller-Armack stressed that the social market economy was conceived as an open system.

The essential features of the social market economy can be considered as basic building blocks of an institutional economic order. Two considerations are important here:

- At the heart of economic considerations are people and their individual wants and needs, which can be as different as the people themselves. For the satisfaction of material needs, given resources are used – at least

when looking at it from a short-term perspective. Besides goods, i.e. products and services, the term resource includes particularly the factors of production, i.e. labour, capital and land. The availability of the factor of production labour depends on the number of employable people and their ability (human capital), as well as their mobility. Generally, one has to take it for granted that different people have different kinds and degrees of ability. Capital mainly refers to production plants (produced means of production). Their capacity to produce goods crucially depends on the accessibility and sophistication of the available technology. Finally, apart from land that is agriculturally and commercially used, the factor land also refers to natural resources such as raw materials, air and the environment (natural capital).

- For the equal satisfaction of all needs, because and insofar as the available resources are not sufficient, there is competition for the allocation of the existing resources. From the perspective of potential ways of allocation, the associated means are thus scarce (relative scarcity of resources). The allocation of a resource for the satisfaction of a need therefore implies the impossibility of satisfying other needs with the same means (opportunity cost). This leads to the problem of how to get these scarce resources to where they can be most effectively used (problem of allocation). In terms of the economic principle, the answer is as follows: it is exactly that manner of allocation which, as a result of the application of the respec-





tive resources, leads to the highest possible needs satisfaction. This principle also demands that for the satisfaction of a given need, no more resources are to be used than absolutely necessary. In other words, scarce resources must not be wasted in order to allow the maximisation of the overall economic benefit (*→resources protection*).

To solve the problem detailed above, a number of alternative coordinating procedures can be used. These procedures characterise specific economic systems. One such practical form of coordination mechanism is the *→market economy*. Its most characteristic feature is the fact that the principle of decentralised allocation is adhered to at all times.

When several actors willing to make an exchange come together and act voluntarily, the decision is made on which resources should be used, where and how. This is the definition of a market. The market as a coordinating system ensures that individual economic plans result in a favourable outcome for all. The economic agents therefore play the role of suppliers and consumers of scarce resources in the respective market. This refers to the factors, goods, money and foreign exchange markets. This is where they are in *→competition* with one another, trying to make their respective plans compatible with those of the other side of the market. This macroeconomic coordination process works through prices, which form as a result of *→supply and demand* in the market (*→market mechanism*).

As a sign of free market processes, prices reflect on one hand the opportu-

nity costs of production and thus the degree of scarcity of the respective goods. On the other hand, prices are an expression of the readiness of a person to pay, thus showing how highly the produced goods are valued by the consumer. It is these characteristics that allow prices to fulfil their function in the market.

- The price system sends messages to the market participants indicating which goods should be produced, in what quantity and quality. Prices also indicate in which way and where production will be most profitable. As a result of the *→globalisation* of trade relations, the price mechanism also channels resources regionally and thus contributes to international competition for location. To this extent, the allocation of resources corresponds to the economic principle.
- The remuneration of the factors of production relative to their respective contribution to the goods supply stimulates performance. Thus remuneration as the price for work creates an incentive for the development of individual performance. Similarly, an anticipated *→profit* as a risk premium for the invested capital promotes the readiness to take the associated risks. From the point of view of initiative, competitive prices also act as an incentive for technical progress, to produce goods more cheaply (process innovation) and to improve products while maintaining prices, or to develop new products (product innovation).
- In the end, demand preferences and price signals ensure that the national

product which has been achieved is divided up fairly among the economic agents, in proportion to the individual contributions of its production. This defines the distribution of incomes in terms of the market.

Even while fulfilling their coordinating function, prices certainly cannot prevent erroneous individual decisions, which the economic agents take on the basis of extremely limited information. Investment decisions, for example, are based on a calculation anticipating profits, which obviously, as time goes on, can prove wrong – with the consequence of losses.

Crucial in this context is the fact that under competitive conditions, such erroneous decisions will not last. Rather, the expectations will be modified and the decisions will be corrected, which means that the participant either adjusts to the market or gets out. This learning process by trial and error is therefore referred to as a market-inherent correction mechanism for erroneous individual decisions.

This shows that the market has an informing and a coordinating role to play, which is an essential pillar of the respective economic system. Commercial exchange activities between individuals presuppose that the resources to be exchanged are under their direct control. Thus the most important constituent component of the social market economy has been mentioned, namely, the existence of private property rights (→*property*).

In order to guarantee this right, the economic agents of a country agree on laws which ensure these property rights, thus creating a legal framework

for the protection of private property and the right of the individual to dispose of it. This particularly secures the individual freedom of disposal of private resources for the consumption of income on the one hand, and for earning income on the other. This refers to the employment of resources for production purposes (investment) and equally the investment of the personal ability to work (choice of occupation and place of work) and the necessary training (choice of place of training). The legal protection for the exchange of resources is derived from the legal principles of freedom of commerce and freedom of trade. Individual freedom of action, however, ends when it starts to restrict the liberty of a third party unfairly.

The motivation for the participation in the production process is the self-interest of the economic agents. As suppliers of goods and services or as investors, competition forces the market participants to apply the factors of production economically – this applies equally to profit-oriented and to achievement-oriented →*enterprises*. As consumers, the individuals use the incomes and profits they have earned in order to derive maximum utility, with the consequence that the utilisation of the goods that have been acquired takes place according to the economic principle. The effect of the ‘invisible hand’ (Adam Smith, *Wealth of Nations*) working in that direction, makes the economic activities of private individuals compatible with the general necessity to use scarce resources efficiently.

However, the principle of self-interest described here cannot be equated with pure egoism. It corresponds to the

desire for social recognition, for 'sympathy' (Adam Smith, *Theory of Ethical Feelings*). The result of this is a (partial) matching of the public and private concepts of utility ( $\rightarrow$ liberalism). This explains, for example, the frequent voluntary involvement by citizens in non-profit organisations and honorary posts.

In this way, the market brings about an overlap between public and private economic goals. But the postulate of macroeconomic efficiency stands side by side with the desire of private market participants to secure their existence and to achieve economic freedom. This freedom is therefore also reflected in the amount of scarce resources that private individuals have at their disposal, since this represents their personal prosperity. Private economic objectives certainly do include a more or less marked interest by individuals in social and economic security. This want can potentially justify the political demand for state redistribution in two ways:

- If and insofar as the majority considers the distribution of the economic prosperity which comes from the market (primary income distribution) as unbalanced or unfair, private citizens may fear that, in reaction, the poorer members of society could decide to undertake a redistribution by force (by robbery or theft). Apart from the direct threat to the victims, the status and organisation of private property would equally be at risk, and the very foundation of the market economy itself would be shaken. Therefore, unless the social system is subjected to more extensive governmental repression, the idea of ensuring social peace through the institu-

tionalisation of state redistribution (protection motive) is obvious.

- This interest in state redistribution can also be useful at a personal level. It is true that there are incentives for the voluntary redistribution of income and capital within social core groups, such as within the context of the family or regarding private donations to charities. But due to the increasing size and anonymity of social structures, this approach soon becomes unsatisfactory since private solidarity cannot keep up. Moreover, certain life-threatening risks are only marketable to a limited extent; they cannot therefore be dealt with privately (insurance motive). As a result, the government or parastatal institutions ( $\rightarrow$ parastatals) are tasked to undertake a complementary (and compulsory) redistribution. The history of a special liking for social security in Germany goes back to the 19th century and was influenced by times of economic hardship due to the world wars. The associated 'mentality of entitlement' has meanwhile become a more strongly pronounced social value in Germany than in many other countries.

A  $\rightarrow$ social system based on this has been constitutionally guaranteed for the Federal Republic and the states (social state directive). This system finds its general expression in basic social values such as the protection of human dignity, the protection of marriage and family, and the societal restrictions on individual property rights. These basic values have also been incorporated into regulations of administrative, economic

and industrial law. In the public budgets – on the income side – they affect the taxation system by focusing on redistribution (→*public revenue*).

As far as expenditure is concerned, their hallmark is a complex combination of benefits in kind and cash payments (→*public expenditure*). Of special importance here are transfers to persons with reduced earning capacity. In cases of →*unemployment*, illness or incapacity, these are supplemented by social security benefits. Based on economic policy considerations, there are benefits for enterprises (→*subsidies* and tax reductions) granted by the state for redistribution purposes, although their justification and extent remain controversial.

This concludes the outline of the basic economic components of the concept of a social market economy and of how these components are reflected in the term itself. The following paragraphs go into more detail.

There is, first of all, the economic institutional order with its intention of establishing rules for the economic exchange activities of private economic agents and of enforcing these rules. This characterises the constitutional state under the rule of law, where the personal responsibility of the citizens is given special emphasis (the principle of →*individual responsibility*) and where the individual contributions to the national product determine the reward (→*achievement principle*).

The subsidiarity principle demands that the self-sufficiency of the individual be protected against state interference: the abilities of individuals or their family group to solve problems are to

be protected against the competence of government authorities.

Considered from a different perspective, the subsidiarity principle also dictates that certain tasks shall be dealt with collectively in areas of life where the private capacities of individuals are not enough (solidarity principle). Such subsidiary collective functions are a characteristic feature of the social welfare state. In the context of the social system, they particularly refer to a comprehensive social service that grants provisions and welfare assistance (the social principle, →*social justice*).

In contradistinction to the market with its focus on performance, the interventions of the welfare state are based on the level of need of its members (the principle of need). Other government responsibilities are addressed through the objectives of the Growth and Stability Act. This is an expression of the commitment by the state to focus its economic policy on a high level of →*employment*, stable price levels (→*price level stability*), a positive →*balance of payments equilibrium* and continued, appropriate economic →*growth*.

It is true, however, that these objectives are in conflict with one another – a situation generally referred to as the magic square. When the task of environmental protection under the criterion of sustainability is added to this as a further objective (→*resource protection*), it is sometimes also dubbed the magic pentagon.

Both the market process and the social security system are, however, occasionally not sufficiently effective, thus necessitating complementary corrections. Regarding market processes, one of the key issues is the fact that in

spite of their coordinating effect, prices cannot always prevent bad individual decisions from being made. This is due first of all to insufficient information, and secondly to the information about the nature of a product being usually distributed asymmetrically among the private economic agents. Under certain conditions, this inevitably leads to poor market results (market failure). In view of the market process, two further reasons for efficiency-based state interventions must be mentioned:

- Market supply and the production output can in the first place be unsatisfactory if individual enterprises are in a dominant market position and abuse this position by creating a lasting competitive disturbance. Occasionally, the production of certain goods requires an initial investment that is so high that it is more cost-effective for one single producer rather than a large number of suppliers to provide an economic sector with the respective resource. In such rare cases, a monopoly-like market form is basically inevitable (natural monopolies). Under certain conditions, therefore, institutional policy measures may be necessary to guarantee workable competition.
- Second, deficiencies in the goods supply are possible if no market develops for certain goods or services. This can happen when specific resources can only be used by a group of economic agents collectively, and if it is not possible or appropriate to exclude individual group members from the use of such resources – even when these individuals refuse to pay a price for such public resources (free riders). Similarly, a decentralised coordination of individual economic plans can be unsatisfactory if the overall economic costs arising from the production or the consumption of the goods concerned cannot be fairly assigned to those who cause them, or if an appropriate attribution would be possible only at an excessive cost (the case of external effects – environment). Another important point is that certain needs are ignored by the market process. This applies in the case of future generations who are unable to articulate and enforce their interests effectively. This can lead to a systematic undervaluation of natural resources. As a result, the state may feel inspired to take measures focused on a lasting environmentally friendly economic development (→*environment-oriented management*).

It is possible that in the context of the activities of the →*social welfare state* systematic misleading incentives are put in place:

- Measures that upset the price structure and its signal function regarding scarcity, such as when government dictates maximum or minimum prices, undermining the information and allocation function of prices. The desired redistribution effects thus have to be paid for with efficiency losses which affect society as a whole.
- By contrast, measures that leave the relative price structure intact and which purely consist of benefits in kind or cash payments can reduce the effectiveness of market incentives. To

this extent, redistribution measures can have a performance-lowering effect. But above all, the redistribution system tends to channel productive energies in the direction of the optimisation of the own distribution position, be it in the shape of transfer-maximising individuals or in the form of subsidy-maximising enterprises (so-called rent-seeking). This shows that distribution measures can cause a prosperity loss affecting the economy as a whole. Political opportunity and changing economic conditions thus subject the social market economy to an ongoing adjustment process. Apart from the self-correction mechanism inherent in the system, the regulations and the social security system also have to adapt to the changed requirements. There is therefore not the one and only or a new version of the social market economy, but rather its current form, chosen at any one point in time and always subject to a dynamic process of development.

In summary, this process involves the underlying concept of two political areas:

Taking into account institutional order policy, the constitutional state is eager to formulate and guarantee the crucial elements of the economic and social constitution. Corresponding policies shape particularly the areas of competition law, the monetary and currency regulations, the financial constitution, the labour and the social security order, as well as environmental policy and foreign trade. With a view to the integration of the domestic market economy into the →*European Economic*

*and Monetary Union*, but also in the light of the background of the global commerce and production network, the adjustment of the institutional framework through →*privatisation* and deregulation measures is gaining ever increasing importance, so that the economic constitution can continue to meet its ongoing challenges both at a national and an international level.

However, in the context of process policy, apart from a policy of stability and growth, the service state is also concerned with the advancement of the social security systems. It is a fact that due to the structural transformation that has resulted from competition and phenomena associated with it – especially a relatively high level of unemployment – the system is overstretched.

It is also important to keep the social security system affordable despite an (in that respect) unfavourable →*demographic development*. Finally, it is essential to balance the inevitable contradictions between institutional order policy and its commitment to competition and process policy with its current focus on redistribution and compensation (→*institutional order policy and process politics*).

Accordingly, it is necessary to meet the demands made on the state to the best of its ability, while at the same time preserving the performance incentives that are actually responsible for the existence of redistribution, i.e. the cake that can be shared. It also has to be remembered that it is the market and the efficiency of its allocations which create the relevant conditions for the social component in the social market economy.

Admittedly, old-style economic miracles are no longer on the cards at this stage of the development of the economic constitution, but prosperity for all definitely still is. In conclusion, and in accordance with the overview given above, the essential structures of the social market economy can be outlined as follows:

- Economics can be described as the handling of limited goods by the economic agents for the satisfaction of wants.
- For a rational economic exchange of goods, a coordination system is necessary. This is the institutional order of economy.
- The social market economy is an institutional order-related programme based on the principles of a competition-oriented economy, linking free personal initiative with social progress, made possible through the economic effectiveness of a successful market.
- In order to be able to fulfil this function, the institutional order has to meet a number of constitutive conditions. The structural elements which need to be mentioned are: private property, freedom of production, freedom of action, freedom of trade, free choice of occupation, free choice of workplace and freedom to consume.
- If these conditions are met, the interests of suppliers and consumers will meet in the market under competitive conditions. The price which develops during this process fulfils several roles – the balancing and the signal role, as well as the control and the incentive role.
- Yet, the market system does not always function smoothly in every case. Just like the desire for →*social balancing*, various disrupting factors – either of an external nature or inherent in the system – require corrective measures in order to allow the objectives of the concept to become and remain a reality.
- Government interventions can be found in policies affecting the institutional order of economy or the economic process. The large number of available instruments and institutional regulations must be examined to see whether they are compatible with the system. And when social goals are aimed at, a reasonable ends and means relationship must be observed so that resources are not wasted. This can be ensured only through solidarity and the application of the subsidiarity principle, which neither undermines the motivation for personal initiative and personal responsibility nor ignores or exaggerates social responsibility.
- Political opportunity and changing economic conditions have the consequence that the social market economy is subjected to constant adjustment processes. As such, the legal regulations and social security system must also be adapted and changed. There is therefore not one final version but only a specific form of the social market economy at any one

point in time, which in the context of the principles mentioned is in an ongoing, dynamic process of development.

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### Social market economy: Social irenics

The concept of social irenics goes back to Alfred →Müller-Armack. Irenics refers to the theory of peace. The term itself is derived from the Greek word *eirene* (peace) and from the name of the Greek goddess of peace, Eirene, daughter of Zeus. In its specific sense, Müller-Armack used the term to:

- illustrate a social idea which links all the various world views; and
- connect with the social dimension of the institutional order of economy known as →social market economy.



Central to the former way of using the term is the question how, even in the case of dissimilar approaches of social theory and despite existing differences, the organisation of the →*social system* can be understood as a common task. By way of example, Müller-Armack applied this idea to the intellectual situation of the Western European world after the Second World War, when he considered Catholicism (→*Catholic social doctrines*), Protestantism (→*Protestant social ethics*), →*socialism* and →*liberalism* to be the prominent philosophical positions, and simultaneously predicted that probably none of them could be displaced in the foreseeable future, but that equally none would become absolutely dominant over the others.

Social irenics suggests how one should deal with the inevitable co-existence of differing world views. It is less a matter of blurring existing contrasts than of accommodating and reconciling them under the condition that 'the division is accepted as a given, which however does not terminate the effort to achieve unity' (Müller-Armack 1950, p. 563).

Müller-Armack therefore referred to as 'false irenics' any attempt to explain away philosophical positions that differed from one's own position. Only if equal co-existence of different intellectual and philosophical positions is acknowledged can irenics be successfully applied as a possible solution. Each group of world views is faced with the task of overcoming its own isolation by integrating the missions and perspectives of others into its own thinking. Müller-Armack was thus of the view that specific positions need not be completely abandoned, and that during the

irenic process of reconciliation all differences (contrasts) need not necessarily be overcome.

If, however, the attempt to find common ground in fundamentally contrasting world views is not supposed to be utopian and fail, one has to take into account that this common ground is hardly going to be found in a concrete social system, but most probably in an abstract moral idea of a social concept. Such an abstract universal idea of a social concept could attain a high measure of acceptance as it includes value judgments for which a consensus can be achieved.

In democracies, such fundamental values consist above all in the acknowledgment of liberty and →*social justice*. These two values also form the basis of the concept of the social market economy. Combining the efficiency of a free market with social balancing in such a way that politically and economically both aspects receive sufficient attention, requires the ability to look at issues from different angles and to weigh up the existing options against one another.

Müller-Armack did exactly this when he developed his concept of the social market economy, differentiating it from other economic and social theories and practices. To this extent, his concept is itself an example of a social irenic approach. It is both an independent social idea which goes beyond any individual world view, and an integrative, open stylistic concept about the humanisation of society through social structures which are aimed at equality and the irenic reconciliation of conflicts.

At the same time, the social market economy as a concept of society

becomes a particularly concise example of a scientific but practical approach, which is characterised by the fact that economic theory is applied to actual social circumstances and demands.

The appropriate instrument is shaping the institutional order policy (*Ordnungspolitik*) through which the free market can be fine-tuned in such a way that everybody benefits from the social cooperation. The allegedly irreconcilable values of liberty and justice can thus be potentially reconciled in a specific way, which is not the usual compromise (where there is a winner and a loser) but by moving in the direction of a win-win situation.

The social structuring of income as well as infrastructure and environmental investments were particularly important to Müller-Armack, who wanted to ensure the prosperity of the broadest sectors of the population. Furthermore, in his view, the struggle for a socially acceptable organisation of the regulations governing  $\rightarrow$ *industrial relations* ( $\rightarrow$ *co-determination*) was also an example of an irenic approach in the economy.

From the ethical perspective of striving for social harmony, Müller-Armack referred to the social market economy as an 'irenic formula' that 'tries to bring about a reasonable balance between the ideals of justice, liberty and economic growth' (Müller-Armack 1969, p. 131). At the same time, it appears to be an attempt to achieve public aims that serve the common good on the basis of a stable order and to resolve  $\rightarrow$ *conflicting aims in economic policy* peacefully.

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### Social partners

In Germany, trade unions and employers' associations are frequently referred to as social partners. Firstly, this is supposed to be an indication that the concept of class struggle is a thing of the past. It indicates, secondly, that they are collective bargaining partners and as such are obliged, in terms of the Basic Law and in the context of the freedom of coalition and bargaining autonomy, to make a positive contribution 'to the preservation and promotion of conditions in the workplace and the economy as a whole' (Basic Law, Article 9(3)). In this sense, the social partners are playing an important part in making the  $\rightarrow$ *social market economy* work.

At enterprise level, in terms of s. 3 of the Industrial Constitution Law, works councils and management are encouraged to cooperate as operating partners in a spirit of mutual trust and for the benefit of the workers and the enterprise. For the protection of workers' interests, graduated rights to informa-

tion and hearings as well as more extensive rights to co-determination are on the agenda (→*industrial relations constitution*).

At association level, trade unions and employers' associations as bargaining partners negotiate the details of the general working and remuneration conditions. Collective wage agreements made possible through the autonomy of bargaining are supposed to make up for the structural inferiority of individual workers opposite their employers.

At national level, through representatives chosen at union and management elections, the social partners participate in the independent administration of the social security services, the →*Federal Employment Agency*, as well as the jurisdiction for labour and social security matters.

At the supranational level, within the European Union, joint rights to be granted a hearing and to make recommendations form part of the social dialogue with the European Commission. Furthermore, the social partners participate in the →*International Labour Organization* and its recommendations.

A point of contention, however, is the issue of how far the social partners should become involved in the formulation or implementation of government policy measures, such as in the context of a →*concerted action* or in the 'Alliance for Employment'.

In principle, it would certainly be desirable for the social partners to bring their economic and socio-political expertise to the table, but this must not result in an elimination of their respective responsibilities. It is more important for the bargaining autonomy to take some of the load off the state and to

counter the politicisation of labour conflicts.

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## Social partnership

The first time that labour relations were described as a social partnership was in 1947, in the context of the concerted reconstructive efforts by trade unions and employers. The reconciliation of interests in the spirit of social partnership has since then not only ensured that in Germany labour disputes have remained comparatively infrequent, but it has also been instrumental in the economic and social progress from which large sectors of society are deriving visible benefit.

Social partnership thus represents a cornerstone of the social market economy intended by its architects as a lesson in peace, which is supposed to persuade the main creative forces in a society to solve their conflicts through consensus.

However, the danger still exists that individual interest groups, such as the collective bargaining partners, will try to defuse their conflicts by coming to an agreement at the expense of a third party (→*social partners*).

Correctly understood, a social partnership therefore needs to emphasise that, apart from differences, there are also common interests. It also needs to remind people of their social responsibilities. This commitment to the common good is necessary for the harmonisation of labour relations to link economic and social efficiency, and thereby to achieve an altogether higher degree of social security. Social partnership represents the attempt to reconcile the postulates of →*Protestant social ethics* with the concept of a liberal economic institutional order.

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## Social policy

The term social policy refers both to an area of political activity (applied social policy) and to the academic work being done at international, national and business levels (the teaching of social policy).

The social policy of a government concerns that aspect of political acting which, by applying appropriate means, wants to improve the economic and social positions (= circumstances) of groups of people who either absolutely or relatively (i.e. compared with others) are regarded as weak – for example, because they are not capable of earning a subsistence level →*income*.

The need for social policy exists in every developed society that has a high degree of division of labour, independently of the →*economic order* of the society.

In the absence of social policy, the following problems would arise:

- The subsistence of incapacitated or partially incapacitated individuals (children, the aged, the sick, the disabled and the unemployed) would not be secure.
- Because innate and acquired abilities can differ as much as the opportunities to apply them economically, the consequent differences in income and capital would be so significant that they would have to be (partially) balanced.
- The business managers' efforts to achieve maximum efficiency could endanger the health and other basic interests of the workforce (such as

sufficient time for recreation and decent working conditions).

- The structural transformations associated with economic progress can cause adjustment problems (depreciation and dismissal of human capital, bankruptcies) which for reasons of →*social justice* must not be borne only by those concerned but by the greater society.
- In certain sectors, particularly in the job markets (→*labour market system*), the agricultural commodities markets (→*agricultural policy*) and the insurance markets, the market fulfils its function insufficiently, and because of market failure is responsible for unfair treatment (such as through excessively low wages in job markets which lack trade unions) or when certain economic agents are disadvantaged (private insurance schemes, for example, do not offer cover for unemployment, inflation and serious medical risks, and frequently also only protection in insufficient quality and quantity).

Social policy therefore covers the following areas:

- Worker protection policies, including the limiting of working hours, the prohibition of child labour, the protection of children and young people, the legal protection of expectant and nursing mothers, the protection of the disabled, the prevention of accidents and occupational hazards, as well as the protection against unfair dismissal (employment protection) (→*occupational health and safety*).
- The social security system, which through →*pension*, →*health*, →*nursing care*, →*accident* and →*unemployment insurance* schemes, protects the majority of citizens against the economic consequences of temporary or continuing disability in old age and in times of reduced earning capacity, and which also protects widows, widowers and orphans. In addition, it provides cover for illness, private nursing care and unemployment and, through the →*basic social security* services, also protects from hardship those who have not earned any claim to social security.
- Factory (plant) and industrial relations policies give the workers the right to information, objection, consultation and co-determination with regard to the organisation of the workplace, work routine, working hours, forms of remuneration, employment and dismissal (→*industrial relations constitution*, →*co-determination*).
- →*Labour market policy*, whose efforts to improve the quality of the job markets are supported by the labour administration (→*Federal Employment Agency*). By changing the forms of the job market through the freedom of coalition and the autonomy of bargaining, labour policies also contribute to an economically and socially acceptable wage-fixing process (→*labour law*, →*industrial action*, →*social partnership*).
- →*Housing policy*, which is aimed at giving all citizens access to housing with quantitative and qualitative minimum requirements.

- →*Family policy*, which through financial benefits makes it easier for families to meet their commitments, and which creates basic conditions that are favourable for families.
- →*Education policy*, which is aimed at making up for unequal starting opportunities and at the formation of sufficient human capital.
- →*Wealth accumulation policy*, which is aimed at a broader distribution of material assets and which will help to counterbalance the concentration of increasing wealth in the hands of a few.
- →*Middle class policy*, which is supposed to assist the largest possible number of people to lead an independent existence.
- The policy for the support of youth and the aged, which is for the protection of the economically weaker rather than the gainfully employed; it is supposed to ensure the necessary provision for their respective age-related needs.
- To secure and increase material freedom through personal opportunities for becoming gainfully employed, a system of social security and a policy for combating poverty.
- To implement social justice (equal chances and fairness of distribution).
- To protect social harmony (peace).

Before these main goals can be achieved, certain instrumental goals have to be tackled:

- The protection and recovery of health (worker protection, health insurance).
  - The creation, preservation and improvement of one's chances of securing gainful employment as an independent, secure basis of existence (education and labour market policy, worker protection).
  - The protection of human dignity and free development of the personality (worker protection, plant and industrial relations constitution, and policies for housing, the youth and the aged) based on the principles of equal treatment and →*social justice*.
  - Social security through the creation of appropriate conditions for gainful employment (labour market, education policy) and a system of interpersonal income redistribution (→*distribution*) in the event of incapacitation (social security system, social security assistance). The maximum goal of social security is the maintenance of one's standard of living, while the
- The authorities implementing the national social policy are the federal government, the states, districts and municipalities, the so-called →*parastatals* (pension insurance scheme, health insurance scheme, etc.), non-governmental charitable organisations (Caritas, the Welfare Organisation of the Protestant Church, the Red Cross), as well as the trade unions and employers' associations.
- Germany's social policy is focused on three main goals (→*social state and welfare state*):

minimum goal is to live with dignity at subsistence level.

- The compensation (balancing) of differences in income, wealth and financial commitments through redistribution policies (the social security system, education, family, wealth accumulation and housing policy). In the pursuit of social policy objectives, certain organisational principles should be adhered to (→*social system*).

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### Social policy: International

The social security systems are in need of restructuring. To this end, many countries are searching for a new paradigm. In terms of the global economy, the growing international location competition has led to changes in the division of labour, and increasing regional interconnections between economic and social spaces.

When different socio-political concepts meet, each with its complex

labour, social and environmental standards – and compete with one another – the result is intensified competitive and adjustment pressure (→*systems competition*). But even at a national level, permanent mass unemployment and demographic changes have created new challenges which demand a conceptual reorientation of what used to be a clear demarcation between private and public risk prevention.

International social policy is investigating different ways of structuring social security systems. Empirical comparisons of practical social policies are carried out and new theories are considered. The main objective is to find solutions for each of the areas of risk prevention which express a specific socio-political stance, and which have been tried and proved successful in other countries (best-practice procedure). These solutions could then be adopted at home and internationally, either unchanged or modified.

If the significant developmental differences between countries are considered, as well as their specific problems and their historical and cultural backgrounds, it is doubtful whether this scientific and political cooperation will lead to international agreements on mandatory social minimum standards or even to a universally accepted world social model (which may not even be desirable). It should, however, be possible to see qualitative improvements regarding socio-political effectiveness, efficiency and transparency. If and to the extent that international social policy succeeds in developing the theoretical components for a universally applicable theory of social risk prevention, it could be used worldwide to build,

reform and transform national social security systems. This would contribute to international harmonisation and integration.

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### Social state and welfare state

The currently prevailing legal opinion is of the view that the social state clause in the Basic Law represents the authorisation and appointment of the legislature and the administration to involve themselves in the organisation of the social system and to work towards the aim of social justice and social security in a liberal-democratic order (Stern, 1987, column 3272 f.).

A country is considered a welfare state when:

- it offers assistance to those affected by exigencies and poverty, ensuring an appropriate subsistence level;
- it focuses on legal and actual equality by doing away with socio-economic disparities and dependent relationships;
- it grants social security in relation to accident risks and the risks of illness, premature incapacitation, →*unemployment*, old age, the need for private nursing care and the loss of the breadwinner; and
- it nurtures prosperity and ensures that the →*distribution* of this prosperity can be considered as just (Zacher 1989, p. 29).

According to the Basic Law, Germany must be a 'democratic and social federal state' (Article 20) where 'the constitutional system in the states ... is based on the principles of the republican, democratic and social state under the rule of law' (Article 28). The precept of the social state, which is central to the Basic Law, can be refined with the help of other Articles in the Basic Law that refer either to objectives contained in the concept of the social state or to the delimitations of its welfare activities.

In the case of specific social groups, such as low income earners, basic rights do not become automatically effective just because they are legally granted; they require additional conditions in order to be fulfilled. Thus the social state has the important task of having to ensure that in the context of the constitution and limited financial means, the conditions for an adequate existence for as many members of society as possible are guaranteed. In order to succeed in this, it is necessary to go beyond the formal guarantees of the Basic Law and to set minimum government standards that provide the material basis indispensable for the realisation of the basic rights of personal liberty (Article 2(2)), free development of personality (Article 2(1)), equality before the law (Article 3) and free choice of occupation (Article 12).



The logical consequence is that economically weak members of society have to be provided with a minimum income to secure their existence and give them at least some space for the free expression of their personality. Article 6, which places marriage and the family under special public protection, asks that measures be put in place by the social state to enable families to fulfil their crucial social tasks more reliably (→*family policy*).

The delimitations of the involvement of the social state result from certain fundamental rights, since socio-political activities of a certain nature and predetermined extent (such as far-reaching social policies implemented by any state or especially a socialist state) can interfere with personal liberty, personal responsibility and human dignity. For these reasons – and because in a pluralist, multiparty democracy with strong associations further norms have to be considered – the subsidiarity principle and the principle of plurality are equally of importance. The latter, interpreted as pluralism in the philosophical and political sense, requires independent social institutions (kindergartens, schools, hospitals, homes for the elderly, institutions offering counselling and care).

Countries that over-emphasise their role as social states are called welfare states. The dividing line between the social state and the welfare state has been crossed when individuals, to a large extent, no longer have to worry about their livelihood and their future. If this happens, the subsidiarity principle will have been ignored and the solidarity principle will be sufficiently extended for an attitude of entitlement

and fierce defence of benefits obtained. The consequences of this would be the violation of fundamental social values, such as personal liberty, fair reward for personal performance (→*achievement principle*) and personal initiative and responsibility.

Furthermore, when enterprises and citizens have been burdened with excessive tax and social security contributions, and technical equipment has become outdated as a result of disproportionate (maintenance) →*subsidies*, the economy will suffer domestically and will no longer be able to compete internationally.

In the political and academic domains, opinions differ about exactly where and when the welfare state starts, but there is widespread agreement that the following areas of social policy and of the →*social system* have to be developed by the social state:

- Social insurance and →*basic social security*.
- The world of labour through (in the case of the German example) policies regarding worker protection, the industrial relations constitution, the labour market order and labour market process and full employment.
- The economy in general through an →*institutional order policy* regarding competition and a policy for the protection of those who are economically vulnerable (such as policies for consumer protection and protection for tenants and expectant and nursing mothers).
- The education sector through a poli-

cy aimed at equal opportunities (→*education and research policy*).

- The living conditions of families and economically weaker households through family and →*housing policies* and through policies of (carefully proportioned) redistribution of wealth and income.
- The environment through an →*environment-oriented policy*.

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## Social system

In the wider sense, the term social system refers to the organisation of a society and all the rules and institutions relevant for its structure and for the relationships between its individual members and social groups. In the narrower sense, the term designates all the institutions and norms that determine the social status of individuals and groups in a society – insofar as there is an economic aspect to it (such as due to →*income*, assets, profession). But it equally refers to the regulation of eco-

nomically based social relationships between society members (such as employer-employee relations). In this sense, the social system is a sub-system of the organisation of a society.

The economic and the social institutional order are interdependent; as sub-systems of the organisation of a society they belong at the same level, meaning that basic economic and social goals should be awarded the same rank.

The social quality of a society depends particularly on the economic institutional order, because economic conditions have a profound impact on the social position of individuals and groups.

Among other things, the social status, social position and social security of individuals and groups depend on the way income and property are distributed, on the equality or inequality of personal opportunities and on the chances a person has to achieve economic success.

The specific social content inherent to economic institutional orders varies depending on the conception of what is socially desirable (→*social policy*). For example, the basic social content in the industrial societies of the 19th century was very low. The livelihood of the workers and their families was continually at risk because there was no social assistance for living expenses in the event of illness, unemployment or old age. Excessively long working hours and working conditions that were sub-standard represented health hazards. Housing conditions were appalling. In contrast to this, the →*social market economy* of Germany offers a high basic social content.

Based on the moral concepts pre-

vailing in a  $\rightarrow$ *social state and welfare state*, the level of the basic social content in an economic institutional framework is determined based on:

- whether it is able to boost economic development and to distribute the accumulating income ( $\rightarrow$ *distribution*) and capital ( $\rightarrow$ *wealth accumulation policy*) in a performance-related manner (prosperity for all);
- whether it is able to prevent  $\rightarrow$ *unemployment*;
- whether it is able to cover the living expenses of members of society who are unfit for work or are poor achievers;
- whether it is able to guarantee purchasing power stability, since a decline in purchasing power hits low income earners hardest and favours the owners of material assets ( $\rightarrow$ *price level stability*);
- whether it is able to limit personal dependence and to guarantee basic human rights; and
- whether it is able to assert economic and social group interests through the freedom of association and to bring about the reconciliation of interests, particularly between employers and employees ( $\rightarrow$ *social partnership*,  $\rightarrow$ *co-determination*), between consumers and producers, and between individuals and society.

The basic social content in any given economic institutional order depends on the extent to which the

society, in the course of its development, has been able to make room for social norms as opposed to economic ones. Experience shows that the economy by itself does not generate many social standards other than those on whose fulfilment the functioning of the economy depends.

Generally, social interactions with a commercial purpose tend to be subject to the rule that finite means must produce a maximum yield, or that a certain yield should be achieved at minimum expenditure. This is why a society has to introduce and implement an institutional framework which takes care of its non-economic needs, and, above all, the goals of  $\rightarrow$ *social justice*, social security and social peace.

Economically and socially, the system as a whole will be more satisfactory as it succeeds in integrating both economic and social goals in the different sectors of the economy – such as the monetary, labour and competition order and the works constitution – while organising the elements of these sub-systems in such a way that the social objectives are assigned an independent status, and conflicts with economic policy objectives are minimised.

In order to fine-tune this system so that both economic and social goals have the best possible chance of success, the decisions on which principles the economic and social institutional order will be based are crucial.

Among the relevant principles are personal responsibility, subsidiarity, solidarity, self-reliance and the principle of the social state, as articulated in Articles 20 and 28 of the Basic Law. The principle of personal responsibility ( $\rightarrow$ *individual responsibility*) demands that the

restriction of personal liberty and autonomy through social policies should be kept to a minimum.

The subsidiarity principle demands that no social institution should take on tasks that individuals or smaller social organisations can manage at least as well – meaning that self-help is preferable to external help; but it nevertheless demands that the larger institutions lend the lesser ones their assistance to enable them to fulfil their functions.

The solidarity principle is based on mutual support and ethically based mutual responsibility between the members of a social group (family, municipality, insurance member group); it postulates that similar circumstances and shared interests should be the basis of mutual assistance.

The automatic consequence of the fundamental values of solidarity, subsidiarity and personal responsibility is that the principle of self-reliance has special significance for the social system, particularly in the area of social security. Social self-reliance implies the autonomous, decentralised fulfilment of legally assigned functions according to the subsidiarity principle by solidarity-linked communities. The principle of the social state confers the right upon the state to engage in social activities while at the same time putting it under the obligation to provide the requisite material basis for the full enjoyment of human fundamental rights and especially for free personal expression.

The social security system applies the principles of welfare, provision and insurance. In compensation for claims based on the welfare principle, government aid is granted when there is need, even in the absence of prior contribu-

tions. What kind of aid and how much aid are granted will depend on the specific circumstances of those concerned.

In Germany, the view prevails that the welfare principle as it is applied by the social security services (→*basic social security*) is unsatisfactory, both because of the poorly defined nature of the services and because the services make means testing necessary and the assistance has the character of external aid.

The principle of provision is based on claims arising from services rendered to the government (civil and military service). Individuals who qualify are legally entitled to state benefits which are standardised in respect of their nature and extent. They are funded out of tax revenue.

This principle is disputed as an instrument for the insurance against basic risks, because it runs counter to the principles of subsidiarity and personal responsibility by exempting from social insurance contributions, individuals who can well afford them.

The insurance principle is based on the insight and observation that while in individual cases the occurrence and costs of potential risks cannot be assessed in advance, these risks become calculable since many individuals are all living with similar risks. The services are based on legal claims, standardised in terms of kind and amount. In most cases, family members who are not gainfully employed are covered equally. They are financed through contributions which – unlike those of private insurance schemes – are calculated not on the basis of individual risk probabilities but, according to the solidarity principle, on the basis of what the members can afford.

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Heinz Lampert

### Socialism/planned economy

Socialism is a general term for ideas and political currents, which, particularly since the beginning of the 19th century, stand for social equality and justice with the goal of overcoming the exploitation of human beings by other human beings. To this end, it is postulated that the private ownership of the means of production should legally or factually become collectively or nationally owned (→*property*).

The representatives of utopian socialism – Etienne Cabet (1788–1856) and François Noël Babeuf (1760–1797) – favoured a radical egalitarianism and were advocating state control in all areas of life. Henri Saint Simon (1760–1825) and his followers (the Saint-Simonists) were pursuing the idea of planned, controlled social progress in order to release humankind into justice. Charles Fourier (1772–1837), Philippe Buchez (1796–1866), Louis Blanc (1811–1882) and others saw the basis of a socialist society in the establishment of cooperative partnerships for production and communal living.

Scientific socialism, which dates back to Karl Marx (1818–1883) and

Friedrich Engels (1820–1895), is based particularly on the ideas of the utopian socialists, the Saint-Simonists and their progression towards historical materialism, as well as Babeuf's concept of class struggle.

This is where the concept of administrative socialism as a state-controlled, planned economy originated. Its best-known form is the centrally administered economy in the former Soviet Russia. The collective or national property is centrally administered by government authorities, officially legitimised by Lenin's principle of democratic centralism, incorporated into the nationally planned economy and used for predetermined political goals (→*interventionism*).

Centrally administered economic planning and control of the economic process are based on balance sheets showing the emergence and the utilisation of products. Here an attempt is made to manipulate the material and financial aspects of the multi-level planning process in such a way that the goals of the government plan and the operational plan fulfilment coincide.

Due to the inevitable need to plan quantity, finance and price simultaneously – and with diverging interest on distribution and different concepts of scarcity – the economic organisation of administrative socialism leads to insurmountable information and motivation problems.

The information needed for the planning and control of the economic process is distributed among all the people working at different levels of the government apparatus or in industrial operations and who have been tasked with plan fulfilment.

However, no more than a small part of this information can be centralised and thus made accessible to the national planning authorities. The result is a clash of interests, a principal-agent problem (→*institutional economics*): the interests of the principal (planning authority) and the agent (enterprises) are antagonistic.

As a solution, attempts have been made to motivate the enterprises through financial incentives to put their information into the service of plan fulfilment. But even while the plan is made, enterprises are keen to give a distorted picture of their efficiency in order to be given easily achievable (soft) plans. Likewise, they will want to use tried and tested production methods and avoid innovations, because new production procedures are associated with the risks of change and the danger of missing the operational planning and premium target. This clash of interests cannot be overcome. The result is the universal predominance of soft operating plans and budgets, comparatively low productivity and high levels of hidden →*unemployment*.

Another insurmountable problem of administrative socialism is an economic structure based on the claim of a group of rulers to be exclusively entitled and able to know all the true needs of the people, and to satisfy them with the help of a state monopoly over the means of production. This restriction of consumer sovereignty is one aspect of a sweeping denial of human rights, which also includes political, cultural and religious freedom, and the freedom to enter into contracts and to engage in trade and to travel.

Democratic socialism is linked to

Karl Liebknecht's (1871–1919) idea of unity of socialism and democracy. It pursues – in contradiction to the anti-democratic currents of socialism – a →*third way* between capitalism and administrative socialism, made possible by means of a parliamentary democracy. The 1959 'Godesberg Programme' of the Social Democratic Party can be seen as an example of this.

There are supporters of democratic socialism whose ideas are aimed at a total change of the liberal social and economic system; there are other supporters whose ideas are far removed from such intentions, but who also 'lack an acceptable or stable concept of a political system and who end up getting entangled in insurmountable contradictions. Such ambiguities are usually simply ignored, but they can easily turn into crises engulfing not only the socialist parties, but also the countries governed by them' (Hans Willgerodt).

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Alfred Schüller  
Thomas Welsch

## Societal foundation of economic orders

National economies are organised systems. A →*market economy*, which by definition is mostly self-regulating through the price mechanism (→*market mechanism*), is structured by a number of organisational principles which have a coordinating and behaviour-channelling effect on economic agents (buyers and sellers in the marketplace).

Considered from this angle, real-life economies appear under this coordinating aspect as institutional orders. At the same time, economies are partial systems (sub-systems) of society, the latter being situated at a higher level compared with the economic sector. Thus, in the same way as society as a whole, the economic system embedded in it is characterised by a high degree of structural and functional complexity.

Apart from their feature as a structure, economies also possess dynamic and process-orientated characteristics. Structurally and functionally, economic systems are mainly characterised by interrelationships with other sub-systems of society. These include relationships with the political, social, legal and cultural systems. However, no unilateral dependency of the other sub-systems from the economic system can be assumed, as one is dealing with mutual dependencies.

The ordo-liberal systems theoretician Walter →*Eucken* coined the term 'order interdependency', through which he wanted to express the mutual interrelationships of the economic system with all other spheres of life. Eucken expected the overall system to 'enable man to live life according to

ethical principles' (Eucken 1959, p.132). At the same time, his call for a 'functional and humane order' (ibid., p.21) for the modern economy recognises the determination of the nature of the economic sub-system by society.

The economic institutional order is not simply looked at as a materially efficient mechanism but is also to be shaped by and for man. This means that social values have to be taken into account regarding the processes of a particular economic system and its practical implementation and shaping. The most suitable economic tools for this purpose seem to be →*institutional order policy and process policy*. Institutional order policy sets out the framework for economic processes, while process policy can influence economic behaviour directly.

In games theory terms, one might say that institutional order policy works out the rules of the game while process policy makes the moves. Whether a specific institutional framework of an economy is able to survive relatively unharmed, probably depends on the quality and degree of interdependence with the other sub-systems of society.

At the same time, interdependence is an indicator of the fact that economic institutional orders are not static and unchangeable, but, in their specific form, are subject to ongoing dynamic development.

The inevitable evolution of institutional orders is in the focus of the modern institutional order theory by making recourse to evolutionary approaches. Through these, it is possible to analyse aspects such as 'path dependencies' of development. In the *New History of Economics*, the transformation of the

economic institutional set is seen as part of a general transformation of the institutional framework of society. In particular, the analysis of incentives for economic action is used for the interpretation of the transformational change of the development of the economy and its institutional orders.

Research on the transformation of economic systems accepts that changes of economic institutional orders are usually accompanied by reforms in other social sub-systems, or in fact become possible only thanks to those changes. This was made evident by the collapse after 1989 of the political structures in the German Democratic Republic and in the Central and East European countries.

→*Institutional economics* puts special emphasis on the society-linked foundation of economic structures. This is achieved through an in-depth analysis of institutions, with the intention of demonstrating their stabilising influence on the order of society. Institutions control, coordinate and channel human behaviour by stabilising expectations; thus, for their part, they indirectly have an effect on the structure of the economy.

Institutions are not exclusively or primarily organisations with a specific material and personal structure; equally, rules and standards for human conduct are considered institutions. Formal rules of conduct are the constitution, the legal system, the economic order and contracts. Informal rules of conduct are given by a shared culture, including language, history and ideological attitudes. However, traditions, social and individual customs and moral concepts, as well as norms and

standards, count among the institutions.

In order to make rules and regulations universally binding in the economic sphere, they have to be enforceable, i.e. they have to be invested with the power of sanctions. This clearly shows the mutual interdependence of the economy and the state (the legislature and the executive) as well as the legal system (the judiciary). But the close relationship with the dominant moral code in an economic community becomes obvious. Even without being officially embedded in law, this still controls human behaviour.

In recent years, there has been a revival of thinking in economic styles. The concept of economic style, which was introduced by A. Spiethoff and W. Sombart, is more focused on the societal foundation of the economy than on the concepts of economic order and economic system. Economic style is the actual realisation of a system that tends to be so diversified and multifaceted that a deeper understanding can be reached only through an interdisciplinary programme of research with contributions by economists, sociologists, political and cultural scientists and historians.

It must also be mentioned that the German concept of the institutional order of a →*social market economy* was designed by Alfred →*Müller-Armack* as the blueprint of an economic style whose wide interdisciplinary range can accommodate in equal measure the principles of a market economy and the values of →*social justice* and social balancing (compensation).



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Friedrun Quaas

### Solidarity surtax

With the financial reforms of 1955, the federal government was granted the power to impose surtax both on income tax and on corporation tax (Article 106(1)(6) of the Basic Law). Surtax can be explained as a proportional levy on these taxes should there be a need to fund additional expenditure. It is true that the constitution restricts the amount of this surtax, but there is no time limit. Its introduction does not require the agreement of the Upper House of parliament because it is a federal tax (→*public revenue*).

So far, the German government has made use of this option on only two occasions. The first was in 1968 and was for the purpose of closing predictable budgetary shortfalls. A 3% levy was raised on the income tax and corporation tax. On income tax, this surcharge expired at the end of 1974, while on corporation tax it expired only at the end of 1976. The second occasion was in 1991 when an additional solidarity surtax levy was imposed. The justification in this case was the abnormal burden on the federal budget after the German reunification (→*Reconstruction East*). The solidarity surtax was initially

limited to the 1 July 1991 to 30 June 1992 period. It was levied at 7.5% of income and corporation taxes. In real terms, however, the charge amounted to only 3.75% of the annual tax debt, since it was levied for only half of two calendar year tax periods.

In accordance with the legal regulations of the 1993 Federal Consolidation Programme (or Solidarity Pact), the solidarity surtax was re-introduced in 1995, but now for an unlimited period of time. Initially the surcharge was again 7.5%, but in 1998 it was reduced to 5.5% of both income and corporation taxes. On income tax, however, the surcharge is payable only by persons whose annual income tax bills exceed €972 for individuals or €1,944 for married couples who are jointly assessed.

The solidarity surtax revenue amounts to twice as much as when it was first introduced in 1991. The revenue is stagnating partly due to the country's low economic growth and partly because of income and corporation tax reductions. The solidarity surtax is of significantly greater fiscal importance than the 1968 surtax. By way of comparison, the average annual revenue raised by the surtax from 1968 to 1976 was 1.1% of the federal tax revenue, while since 1995 the revenue from the solidarity surtax has amounted to an annual average of 6.2% of the federal tax revenue.

However, the significance of the solidarity surtax is not restricted to taxation as it also affects the policy of distribution (→*distribution*). Prior to its introduction, the distribution situation was distorted, putting lower and middle incomes at a disadvantage because the shortfalls of the pension and unem-

Germany's solidarity surtax revenue, 1991–2008									
in € billion									
	1991	1992	1993	1994	1995	1996	1997	1998	1999
Amount:	5,4	6,7	0,1	0,8	13,4	13,3	13,2	10,5	11,3
	2000	2001	2002	2003	2004	2005	2006	2007*	2008*
Amount:	11,8	11,1	10,4	10,3	10,1	10,3	11,3	12,55	13,2
* = estimate									
Source: Federal Ministry of Finance									

ployment insurance in East Germany were not financed by all taxpayers collectively, but by West German contributors only. The solidarity surtax made it possible to redress this imbalance through an increased involvement in the settlement of the remaining financial costs by higher-income groups and individuals not liable for social security contributions (such as civil servants and the self-employed). In this way, the East Germans are themselves making an additional financial contribution to →*Reconstruction East*. This fact is frequently overlooked.

After more than 10 years of German unity, one may question how much longer the solidarity surtax can be justified. It is true that starting from 2005 the Solidarity Pact II made provision for further supplementary financial assistance for the East German states from the federal government – particularly for the purpose of removing infrastructural supply deficits – but these were due to be scaled down to €10.5 billion in 2005, €8.7 billion in 2010 and €2.1 billion in 2019. A comprehensive adjustment-based reduction of general net transfers (→*public expenditure*) and social security transfers (such as for rent

subsidies, unemployment pay and assistance and pensions) are not on the agenda for the foreseeable future. If at all, a reduction in transfers is on the cards only as a result of labour market policy (including fewer job creation measures, changed entitlement to services).

The fact is that in the foreseeable future, the East German tax revenue and social insurance contributions might not be sufficient to finance the demands on the public budgets and the social security system. By itself, however, this is not necessarily a sufficient justification for the continuation of the solidarity surtax.

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## Speculation

Speculation is aimed at using commodity price fluctuations between two different points in time to make a profit. The uncertainty about whether prices will actually move in the anticipated direction is part of speculation. The most suitable commodities for speculation are those whose prices tend to fluctuate strongly, such as shares, foreign exchange, derivatives and standardised goods traded in commodity or commodity futures exchanges (including grain, precious metals and raw materials).

Speculation must be distinguished from arbitrage, which uses different prices for a commodity at two different places. In certain cases, however, speculation and arbitrage can coincide. The medieval long-distance trader who was exploiting the price difference for an item between two places, was also speculating on the fact that this price difference would still apply after the often lengthy transport of the item from the place where the price was low to the place where it was higher. However, investments in, for example, shares are not speculation as the long-term share investor does not speculate on short-term fluctuations of stock exchange prices but partakes in the profit growth of listed *enterprises*. The performance of a widely distributed portfolio of standard shares takes place gradually over time – short-term price spikes notwithstanding – and is very steady.

A spot speculation is the purchase of a product now in the hope that the price will rise in the future (in a bull market). If the price increase occurs, the speculator's profit consists in the difference

between purchase and selling price, less the financing costs (interest) for the respective period. However, in the event that the price does not rise at all or not enough to cover the interest, the speculator suffers a speculative loss.

Speculation on falling prices (in a bear market) is possible by selling short: the speculator sells a commodity which he/she does not possess in the hope that by the delivery date its price will have fallen below the agreed price and that he/she can buy it at a speculative profit on the agreed future date and fulfil his/her obligation. Forms of forward speculation include options, where, on the maturity of the option and in return for a fee agreed in advance, one of the contracting parties has the right to decide either in favour of or against exercising the deal.

Speculation has many critics. Profits from speculation are considered as unearned income and speculators are seen as gamblers who profit from the losses of others. Claims have also been made that speculation is the cause of price fluctuations. However, speculation plays an important macroeconomic role, such as in the temporary flattening in the price development of commodities that are subject to speculation. Speculators will make a profit in the long run only if they buy at low prices (and cause the price trend to go up due to this demand) and sell at high prices (and cause the price trend to fall through this offer). However, someone who despite prices which are already high continues buying in the expectation of further price increases, thus stoking up the bull market, or who despite low prices, continues to sell thus speeding up the drop in prices, will

on average obtain no profit from speculation and will have to leave the market.

As a rule, successful speculation tends to absorb price fluctuations, rather than being their cause. When prices do not form independently – such as when the exchange rate is fixed (→*currency system and exchange rate regimes*) – and has to be protected in the foreign exchange market through interventions by the issuing bank (purchase or sale of foreign currency in order to sell or buy own currency) – speculation can have a destabilising effect. Here, speculators can make a profit if they sell an overvalued currency and buy an undervalued currency (international currency system). As soon as the issuing banks give in to the market pressure and adjust the exchange rate, the speculators have secured a profit equivalent to the exchange rate adjustment.

It is more likely that the destabilisation is due to an exchange rate fixing that runs counter to the market, than to the speculation which actually forces an adjustment of the exchange rates in the direction of equilibrium.

In the short term (a frequent occurrence in economic history), speculative bubbles can make prices overshoot by a long way over the long-term average. Typical of bubbles is the hysteria of inexperienced or amateur speculators who ignore not only the economic criteria for the value of a commodity, but also the great effort institutional investors make to predict and utilise short-term exchange rate fluctuations.

After a bubble has burst, equally extreme price drops are just as frequent before normal price levels and fluctuations return. The bubbles are ultimately not caused by speculation but by the

lack of economic knowledge and foresight of amateur speculators, in combination with the herd instinct of people who copy others blindly and are just hangers-on. This is a phenomenon that is occasionally consciously exploited.

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## Statistics

Without general statistically derived information about society, economics and the environment, governments cannot act. The German Federal Constitutional Court judgment on the 15 December 1983 census stated that statistics create ‘an indispensable background for the design of a national policy which is based on the concept of the social state’. In this sense, it points the ‘way into reality’.

Here, the Federal Statistical Act (1953) plays a key role. It was one of the important elements of creating an institutional order of the early post-war period – on a par with the German Federal Bank Act (1957), the Act Against Restraints of Competition (1957), the Foreign Trade Act (1961) and the law establishing the European Economic Community (EEC) (1957). It is therefore also called the Basic Law of Federal Statistics. It is a sign of the quality of this law that in nearly 50 years it has had to be amended only twice (in 1980 and 1987).

This law specifies the position and

functions of the Federal Statistical Office (FSO). Its functions include the methodological and technical preparation of federal statistics so that uniform results for the whole of Germany become available. Beyond this, the federal results are collected and published.

The FSO regulates the arrangement of statistics and appoints a statistical advisory board made up of representatives of the public, including individuals who make use of statistics and others who serve as sources of information. Due to the universal validity of the law, no exceptions or privileges are permissible where access to statistics is concerned.

Statistical surveys frequently infringe on the personal rights of the individual, and citizens certainly often experience them as a nuisance. This interference is permitted by a law which clearly defines the rights and obligations of those concerned during a survey.

Of key importance here are the obligations of individuals to give information, and of the statistical offices to keep individuals' information secret. The refusal to give information is punishable as an infringement of the law, while violation of professional secrecy by the FSO is a criminal offence and punished as such. Specialised statistical surveys are also in most cases subject to federal laws.

If the result of an official statistical survey is the indispensable background for government action, it is also an element of the public opinion forming process. Anyone can find statistics that suit their purpose, since a large number of statistical surveys are carried out under private initiative. It would, how-

ever, be impossible – or at least very difficult – for people to live together in an orderly fashion if there were not only different concepts of the common good but even different views on the reality to which these concepts refer. It is therefore helpful if the political discussion about the social and economic reality is based on a uniform statement of facts.

In Germany it is widely accepted that official statistics are not subject to political direction. They are, rather, an objective method of collecting information and are removed from politics. The results of statistical surveys are therefore not a subject of the political discussion but its precondition. For example, the components of the wage-fixing formula that trade unions apply – the current wages, the inflation rate and the productivity trend – are concrete statistical data in collective bargaining and are undisputed. This remains the case although the clashes of interests between trade unions and employers in the realm of wage negotiations are more extreme than they are in any other sector of society.

In this way, official statistics can make an important contribution to social harmony. In a society where there is no longer a fundamental consensus on the basis of religion or philosophical concepts, statistics can at least ensure basic agreement on social facts.

An important reason why statistics are so widely accepted today is that they are no longer exclusively seen as an instrument of public administration. Originally, they used to fulfil certain administrative functions.

To combine individual statistical data in a 'programme' was unheard of:

there was no comprehensive, general concept, but only a variety of single statistical surveys which had been carried out for specific public administrative reasons.

The universal increase of government involvement, specifically within the economic and social sectors, brought with it an expansion of statistical activities.

In countries and societies with a high level of administration, the official statistical involvement in these same areas is accordingly extensive. It is understandable that the government wants to put its administrative procedures on record, even if just in order to account for its activities.

The ongoing progress of statistics created the necessary conditions for a statistical overview of economy and society. This was helped by the establishment of the FSO. The introduction of national accounting, which was aimed at working out macroeconomic relationships, accelerated this process. Statistical gaps had to be closed, definitions and systems had to be standardised, and the programme had to be expanded.

As statistics were developing further, the accumulated information started to become interesting for the private sector as well as the administrative sector. As a consequence there was a demand for government statistics for business use. The reaction from the FSO was also to supply objective data for sectors of the economy where the government itself does not want to get involved, or where the planned or implemented government measures do not really require an extremely detailed economic picture.

Through official statistical data, the government contributes to the transparency of the market. With the expansion of statistics, the creation of a statistical overview of both the economy and society and the existence of the FSO, important elements of statistics have been brought to life and integrated into the national infrastructure. These represent everything that is required for the permanent material, institutional and personal basis of a properly functioning economy based on division of labour.

This is why statistics are comparable to the transport system and the media, to provision and disposal, and to the educational, health and social security systems, in that they are accessible to everyone – to politics, interest groups, the economy and science.

In order that they can play the role of an informational infrastructure, statistics also have to fulfil other important conditions: statistics alone serve the purpose of a society-related, economic and social statement of facts. If there were the slightest suspicion that official statistics were politically close to government, their function as an accepted part of the country's infrastructure would be in danger.

Lastly, statistics have to be tuned to the needs of the public. This means that the statistical programme is not drawn up once and for all. Rather, it has to adjust its emphases to a developing society while at the same time projecting a comprehensive and consistent image of that society.

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Horst-Dieter Westerhoff

## Structural policy

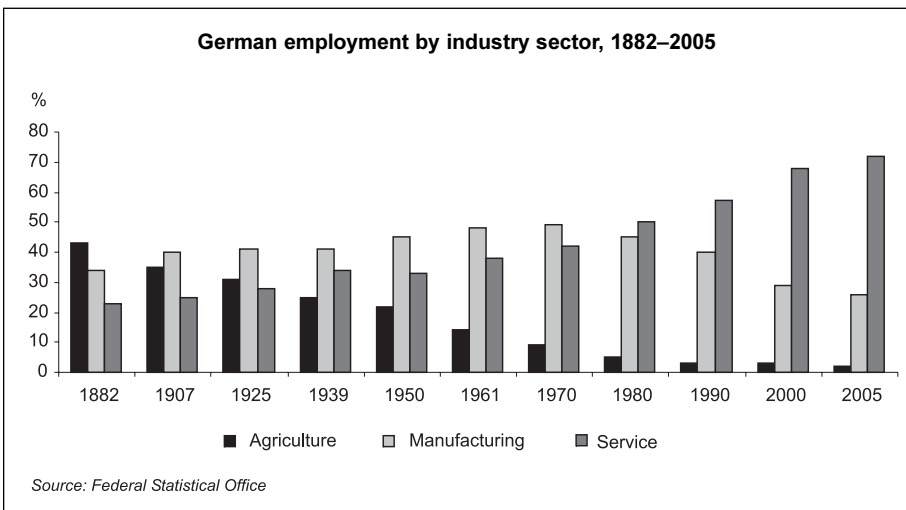
The term structural policy is used in different ways. Frequently, it is simply understood as the structural policy in the different regions and sectors. The following discussion deals with these two political aspects. With reference to the economy, however, the term applies to all political areas, particularly to those of income and  $\rightarrow$ wealth accumulation policies as well as to  $\rightarrow$ labour market policies.

Whenever the structure of economic phenomena and their organisation by the state is at stake, the actual issue is structural policy.

It may seem confusing that structural policy is associated with the most

varied concepts of economic policy: some activists are pursuing the creation of an appropriate and necessary regulatory framework that allows private initiative to flourish in a manner which brings maximum benefit to the society as a whole (such as policies that stabilise the currency, and policies on competition, private property and the environment), while others want to eliminate or disable market forces (such as measures that undermine the market and limit competition; protectionist measures favouring specific industries; the policy of granting subsidies; government interventions that influence investments; and rules, prohibitions or massive discriminating financial incentives or penalties).

When structural policy is mentioned, it should therefore be ascertained exactly which (possibly biased) objectives are pursued with which measures (often opposed to the market). In the political battle of opinions, the true motivation of political measures is frequently disguised and precarious economic policy interventions are



presented as harmless (→*interventionism*).

Regional structural policy continues to be seen as harmless. The 'Joint Task: Improvement of the Regional Economic Structure' is primarily aimed at decreasing the location disadvantages of rural areas and numerous border zones. The EU has established several structural funds which are supposed to help the most disadvantaged and backward regions to catch up. The most important aspect is the development of the economically relevant infrastructure (transport routes, energy and water supply, development programmes for industrial areas), followed by investment incentives and subsidies (→*EU: regional and structural policy*).

Particularly in East Germany, regional structural policy measures were, and partly still are, essential. But it must not be forgotten that ongoing financial incentives can produce an unhealthy reliance on government assistance (mentality of entitlement), which can lead to distorted competition and create the need to grant similar assistance to regions which were previously left out.

Regarding the development of transport routes, the biased support for →*public enterprises* (such as loss-making railways) and the deliberate acceptance of deficiencies in other transport networks for ideological reasons have to be highlighted as a misguided attitude in regional structural policy.

Paradoxically, as far as the different sectors are concerned, the structural policy that is supposed to accompany and promote the constant structural change of the economy has predominantly the effect of maintaining existing

structures. Pressure from organised groups, including trade unions, and concerns about job losses frequently motivate politicians to try to save shrinking industries.

As the history of coal mining and the railways shows, the measures which preserve structures are extremely costly for the taxpayer and, in the long run, only delay adaption but never prevent it. The support of structural preservation is definitely short-sighted. But certain aspects of structural policy in the different sectors are indeed directed at the promotion of structural change.

Occasional claims are made by politicians that they know better than →*entrepreneurs* (who are alleged to be thinking only in the short term) which sectors of the economy will progress rapidly and should therefore be promoted with product-orientated research subsidies (structural policy with foresight). Such statements have regularly been proved wrong and presumptuous, while, on the other hand, the development of promising industries such as genetic engineering and nuclear technology has been greatly hampered for political reasons.

There is nothing to be said against the intensified promotion of basic research and more future-orientated training in skills that are in short supply; this is something that has largely been lacking in the past. In all other respects, structural policy in the different sectors should concentrate on the removal of obstacles to progress in promising industries (restricted entry and government regulations). The promotion of structural change also includes the phasing out of complex and lengthy licensing procedures for



new companies and larger investment projects.

Furthermore, constant extensions to the  $\rightarrow$ co-determination regulations and increasing government control of the job market and of employment contracts, add up to an economically undesirable restriction of the personal rights of disposal. The direct result is a reduced inclination to start new businesses and create new jobs.

One would be mistaken in concluding from the above criticism that it would be best to do without regional and sector-related policies. There is no doubt that structural policy is desirable insofar as it boosts economic progress in the long run. And one cannot object to  $\rightarrow$ social policies that make the consequences of structural change more bearable – as long as these are implemented for a limited length of time. All other basic conditions for economic activities should be designed in such a way that effective incentives for structural changes can result.

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Walter Hamm

### Subsidies, government assistance

In the context of the social market economy, it is the duty of the government to fight any aberrations which may occur in the process of implementing this system. Four weaknesses should be specifically listed:

- The accumulation of economic power in the hands of a few economic agents, which interferes with competition.
- Interference with the price formation process through the production or consumption of goods that generate external effects in the form of external costs (such as unredeemed damage to the environment) or external benefits (such as lasting services in the public interest which remain unrewarded).
- The emergence of an income and wealth distribution which is seen as unfair and a potential cause of social conflict.
- The failure to reach general economic goals (a high level of  $\rightarrow$ employment,  $\rightarrow$ price level stability,  $\rightarrow$ balance of payments equilibrium and constant and appropriate economic  $\rightarrow$ growth).

In order to fulfil these tasks, the state uses – apart from numerous other instruments – transfer payments to enterprises (subsidies) and private households (allowances, social transfers). These transfers (subsidies) are selective concessions without an adequate market-related return and are

granted by the public finance authorities (→*Federal Republic, federal states, municipalities* and the →*EU*) to recipients outside the government administration.

The main reasons why subsidies are granted to →*enterprises* belong to three areas:

- The →*structural policy* in the different sectors that has the function of softening the impact of the economic change (structural →*unemployment*) and accelerating the structural change necessary for economic growth.
- The regional structural policy that concentrates on the distribution of the production potential and the infrastructural development within

the economy; these subsidies are important prerequisites for the creation of equal living conditions.

- The structural policy that focuses on company size (→*middle class policy*). It tries to balance potential competitive disadvantages of small and medium-sized enterprises compared with large enterprises. In the right circumstances, this sort of adaptation to technical and economic change makes the economy more competitive in general.

The government has a number of subsidy instruments at its disposal for the fulfilment of the respective tasks. Their implementation has different (budget-related) consequences for the

Development of financial aid and tax relief measures of the German federal government, 1970–2004 in € million					
	1970	1980	1990	2000	2004
1. Consumer protection, food and agriculture	2,431	1,878	2,947	1,872	1,600
2. Trade and industry (without transport)					
2.1 Mining	272	1,323	1,699	3,991	2,233
2.2 Efficient use of energy and renewable energy sources	10	142	102	68	252
2.3 Technology and innovation subsidies	77	269	273	394	434
2.4. Aid for specific sectors of industry	88	345	775	139	84
2.5 Regional structural measures	1,049	2,172	3,659	2,023	1,786
2.6 Trade and industry in general	395	433	923	4,918	5,818
3. Traffic	463	1,261	1,009	970	1,188
4. Housing	670	1,975	2,355	6,295	6,365
5. Savings incentives and asset formation	1,378	1,964	620	613	595
6. Other financial aid and tax relief measures	309	742	771	1,862	1,938
Exemptions of ecological tax reform	0	0	0	3,252	5,613
<b>Sum total 1. to 6. without exemptions of ecological tax reform</b>	<b>7,142</b>	<b>12,504</b>	<b>15,133</b>	<b>23,145</b>	<b>22,293</b>
<b>Sum total 1. to 6.</b>	<b>7,142</b>	<b>12,504</b>	<b>15,133</b>	<b>26,397</b>	<b>27,906</b>

Source: Federal Ministry of Finance

public finance administration. They include:

- rules and prohibitions in favour of third parties without a direct impact on the government budget (such as import regulations);
- financial assistance, such as in the form of subsidies, refunds or assistance with the servicing of debts, which are reflected on the expenditure side of the public accounts; and
- tax relief, such as in the form of tax allowances, special deductions or tax rate reductions, which result in revenue losses for the budget.

In principle, in a social market economy such subsidy payments are granted exclusively in accordance with the subsidiarity principle as 'help to help oneself', since they are basically opposed to the processes of a free market. On the one hand, subsidies put their recipients in a privileged position relative to those economic agents who are not granted any subsidies (discrimination effect). On the other hand, the taxpayer has to carry the financial burden of the granting of subsidies (redistribution effect). In principle, these effects would be less significant if subsidies did not exist.

The bi-annual subsidy report which is submitted by the federal government classifies the relevant payments according to how they affect the market supply, namely:

- assistance with productivity;
- assistance with restructuring; and
- assistance with maintenance (preservation).

For political reasons, clear dividing lines between these groups are not always desirable. This is also why nothing is ever done about the constant and ubiquitous demands for subsidies to be phased out.

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## Supervisory offices

The public sector – as responsible for economic policy – also has the task of supervising the economy. This is a system-inherent task in markets, where uneven results are anticipated due to suppliers and consumers not being equally well informed about the markets. The state therefore intervenes by means of regulations and supervisory offices, which function as control institutions. The aim of this form of economic policy is to serve the welfare of all by influencing the autonomous private economic activities of households and →enterprises through specific, legal-

ly binding directives and general conditions. These are considered necessary in order to reach and secure the functionality of certain markets, both economically and in their social effects.

Supervisory offices have been given the task of controlling, correcting and sanctioning. In this context, the legislator has to develop a set of rules and rights. Only in this way can the aims, means and standards of interventions be made predictable and measurable for the economic agents concerned, and the same goes for the actions of the supervisory offices (constitutional state principle).

Areas under economic supervision (not to be confused with the state control over →*public enterprises*, which are likewise subject to economic supervision) were, or are, for example: pharmacies, banks, the retail trade, the energy industry, forestry, the food trade, aviation, transport, insurance schemes (industry-bound specialised supervision); industrial safety, the calibration system, emission control (special supervision); and cartels, prices and taxes (general supervision).

This list clearly shows that there are areas of supervision which are categorised depending on the sector or industry in which they fall, while there are also general areas of supervision within the economy as a whole. There is definitely a tendency for economic supervision to become part of every aspect of the economy. These legally specified areas of supervision are as diverse and dissimilar as the actual tasks involved.

The monitoring, and when necessary correction, of the behaviour of the market participants is generally where

economic supervision starts. The aims of economic supervision encompass the protection of a minor contracting party (such as an insurance client), ensuring that individual enterprises fulfil their commitments (for example, hygiene in restaurants), dealing with structural aspects of an entire industry (permission or prohibition of the formation of cartels, →*Federal Cartel Office*) and even protective measures against general threats to the economy (control of the financial markets).

The economic supervisory system is not a uniform, comprehensive, clearly defined organisation. Owing to the diversity of its functions, this would hardly be possible. The fact is that the supervisory powers and the actual execution of the tasks have been distributed among several partially overlapping authorities. Everything revolves around the federal supervisory offices, which are the centre of the organisation and are of great significance in terms of economic policy. These have the status of independent federal authorities within the Federal Ministry of Finance. They deal with the financial markets and are divided into the Federal Supervisory Office for Insurance, the Federal Banking Supervisory Office and the Federal Securities Trading Supervisory Authority.

The classical and most enduring economic supervision (since 1901) is applied to insurance. The legal basis is the Act on the Supervision of Insurance Companies (1931; amended repeatedly). By granting insurance special status because of its social significance, because it needs to be trustworthy and because of its macroeconomic importance, the Federal Supervisory Office

for Insurance (based in Bonn) is essentially pursuing two main aims: protecting the interests of the insured and, in so doing, specifically guaranteeing that the future obligations of an insurance company can be met at all times. Supervisory measures include compulsory concessions, surety obligations, auditing and publicity, monitoring of the management and potential intervention in the running of the business.

The credit system is under relatively comprehensive supervision. Public supervision of the banks, with general responsibility for the promotion of the stability of the financial institutions and the financial system, is predominantly performed by the Federal Banking Supervisory Office, also based in Bonn, in cooperation with the German Federal Bank.

The legal basis for this supervision is the German Banking Act (1961; amended several times). Public supervision of the banks is specifically intended for the correction of any flaws in the credit and financial service systems that may endanger the security of customer deposits, impair proper execution of financial transactions or cause substantial disruptions for the national economy.

The newest supervisory office, the Federal Supervisory Office for Securities Trading, was established in Frankfurt in 1995. Its task is to rectify any shortcomings in the proper handling of securities trading that may cause substantial disruptions to the stock market. The Federal Supervisory Office for Securities Trading also monitors the compulsory disclosure of listed companies, while a further important function is the detection and prosecu-

tion of offenders involved in insider trading.

Against the background of the fast progressing financial market trend towards a bancassurance market, and due to the necessity of an organisational adjustment, what used to be the federal insurance, banking and securities trading supervisory offices were combined in 2002, with all their existing functions being taken over by the newly established and legally autonomous Federal Financial Supervisory Authority (all-finance supervision). This is expected to yield greater supervisory competencies, synergy in the execution of cross-sectional tasks and a general stabilisation of supervisory efficiency.

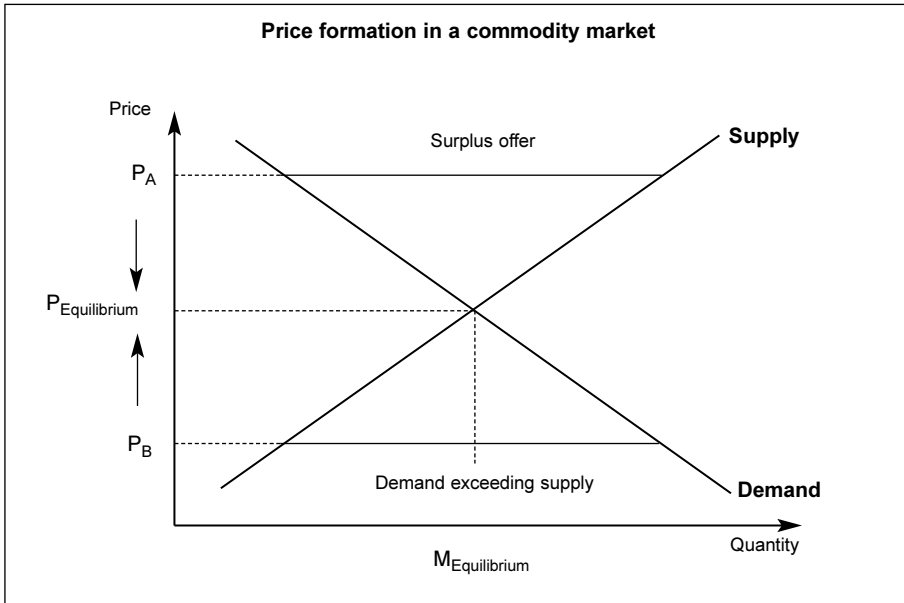
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Dieter Fritz-Aßmus

## Supply and demand

When companies and households work out their business plans, they tend to be guided by self-interest. This means that companies want to make profits while consumers want to satisfy their needs. The players try to realise these objectives in the market place. To this end, suppliers (such as of consumer goods or labour) must go into business with the consumers. Thanks to the competition for consumers among suppliers, every-



one is motivated to make offers capable of satisfying consumer expectations. In effect, the more consistently a supplier is pursuing personal interests, the better consumer needs are served, and the sharper the  $\rightarrow$ competition for available business becomes. As with an ‘invisible hand’ (Adam Smith), competition brings about a situation where self-interest serves the welfare of all by ensuring a favourable consumer supply.

The fact that competition makes the coordination of a multitude of individual plans possible, has led to the concept of the self-regulation of the free market economy. This can easily be demonstrated by looking at pricing in the consumer markets. It is assumed that there are so many different suppliers and consumers that none of them can determine prices on their own (polypoly). Both the supply of and demand for goods tend to depend on how these are priced (see figure). According to the law of demand, the

higher a product is priced, the lower will be the demand for it (falling demand straight lines).

The law of supply means, however, that with rising prices, the quantity of the goods on offer normally also increases (rising supply straight lines). This is to be attributed to the fact that with rising prices it becomes easier to supply goods and at least break even. And while relatively high prices encourage companies to offer large amounts of goods, they do not normally encourage consumers to buy them. The consequence is that initially high prices result in an offer surplus (such as at price  $P_A$ ). This means that the quantity on offer exceeds the demand. But since the suppliers want to sell all their products, they will undercut each other’s prices in order to attract as much demand as possible to themselves. This causes market prices to fall. As a consequence, demand goes up (law of demand), while the supply gradually

goes down (law of supply). Prices remain under pressure in this way until the quantities on offer correspond to the quantities in demand. This happens when prices are at  $P_{\text{equilibrium}}$ .

If the supplier's price is lower than this price (such as at  $P_B$ ), then demand exceeds the supply. There is excess demand, although not all willing buyers can obtain the goods. As soon as the suppliers notice this, they will use the opportunity to increase prices. This will decrease demand (law of demand), while it becomes worthwhile for companies to increase their supply (law of supply).

The price increase continues until again the price  $P_{\text{equilibrium}}$  is achieved. At the equilibrium price the equilibrium quantity of  $M_{\text{equilibrium}}$  is realised. Under stable supply and demand conditions in the short term, this is the maximum turnover that can be achieved in this market: if prices exceed equilibrium prices, demand will fall, and if prices fall below equilibrium prices, the supply goes down. This means that equilibrium ensures an optimum supply of goods.

Prices are supposed to balance supply and demand and to convey the scarcity of the product (balancing and signal effect of prices) to the market. To achieve equilibrium in the short term, however, is not enough. The pursuit of self-interest also leads to an increased supply in the long term.

Besides prices, profits, too, have a regulatory function. They result when prices exceed the costs of the supply. Such  $\rightarrow$ profits act as an incentive for the suppliers concerned to expand their production in order to realise even higher total profits. In addition, profits

gradually attract more companies to the market, and the supply rises further. Growing supply and stable demand lead to a surplus, which in turn depresses the equilibrium price below its original level – to the benefit of the consumer.

Beyond that, companies strive to reduce their costs. To this end, they can copy streamlined production procedures from competitors (imitation) or develop new, still more economical procedures (innovation). Profits can thus again be achieved with goods priced at a given level. However, in the long term, the competition forces the suppliers once more to pass on cost advantages to the consumer in the form of price reductions.

This pricing through competition gives rise to a particularly efficient use of the limited supply of the factors of production. The production of goods that because of consumer appreciation promise generous profits, is promoted. By contrast, companies give up loss-making activities in order to be able to use the liberated factors of production more meaningfully. In addition, competition ensures that the remuneration of the factors of production is performance related. Thus, market players are encouraged to help overcome the scarcity of goods as best they can (prices and their stimulatory and regulatory effect).

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## Sustainability

This term was first used in forestry and started to spread in use in German-speaking countries during the 18th and 19th centuries. It meant that no more trees should be cut down than could grow back. In the Anglo-Saxon world, John Locke (1632–1704) and John Stuart Mill (1806–1873) were the fore-runners of the sustainability debate. Locke urged that resources ought to be used with future generations in mind; similarly, Mill pleaded with his contemporaries to moderate their needs.

The contemporary view was crucially influenced by the detailed report compiled by the United Nations World Commission on Environment and Development *Our Common Future* (1987) (the Brundtland report).

The concept of sustainability rests on three pillars: ecological, social and economic. These all have to be considered. They are causally linked, which means that they are not exchangeable and that they cannot be considered in isolation. Anything that is supposed to be socially and ecologically sustainable also has to be economically viable; only then can social and ecological goals be financed on a long-term basis. However, an economic system that does not give sufficient consideration to social and ecological issues is undoubtedly putting the sustainable satisfaction of needs of the present generation at risk – and, much more so, future generations.

Development is sustainable if it is appropriate to the needs of the present generation, without endangering the potential of future generations to look after their own needs and to choose how they want to live.

Today, sustainability is a concept that enjoys worldwide recognition. This broad acceptance of finding an equilibrium between the interests of today's and future generations, of private and public interest, of North and South, nevertheless runs into difficulties when it comes to laying down practical recommendations for action (→*protection of resources*, →*environmental protection objectives*) – at a national and still more strongly at an international level.

The embedding of environmental and social clauses into the international economic system is controversial and has so far succeeded only partially. The implementation of environmental aims (such as lowering CO<sub>2</sub> emissions) is encountering various obstacles. Nevertheless, increasing awareness and concrete improvements can be seen. Both in politics and in industry there is a growing, visible interest to lend support to a sustainable economy in the light of continually changing economic conditions. If, in future, both politicians and consumers decide clearly in favour of a sustainable economic, social and ecological environment, a sustainable economy will become a factor of competition.

Since in a market economy, enterprises have to strive as much as possible to take investment decisions which help them fulfil demand preferences, the long-term realisation of sustainability requires a lasting change in the priorities of politicians, citizens and economic agents.

This is why sustainability cannot simply be prescribed in a democratic state under the rule of law and a market economy. It remains a political and eco-



conomic policy task to modify the behaviour patterns and to push them in this direction – through means compatible with a democracy and a market economy. This also takes time, but impatience is a poor counsellor.

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Rolf H. Hasse

### System(s) competition

Until the late 1980s, the term system competition was used to describe the →*competition* between democratic systems with free market economies, and socialist systems with centrally planned economies (→*socialism/ planned economy*). Today, it is used as a collective name for procedures and circumstances associated with the system competition between democratic states based on →*market economies*. Institutional competition, regulatory competition (regulatory federalism), competition between governmental judiciary and administrative systems (inter-jurisdictional competition) and location competition are also concepts in contemporary usage.

The issue here is the conditions and consequences of exchange and competitive interactions between governmen-

tal suppliers of and private demand looking for a public service known as 'institutional regulations'. The economic constitution makes provision for such regulations in many sectors. Examples are the regulations governing property, enterprises, production and the market, as well as the social constitution. The formal rules laid down for these jurisdictional areas are also referred to as external institutions and represent an important element of the conditions for the location of an industry.

In an open economic system where capital, labour, goods and services can cross national borders freely, the conditions regarding international competition for mobile factors of production, and particularly investments, change for the countries that set the rules. Domestic investors are subjected to the immobile public good 'institutional organisation', which is tied to a national territory, but they are also mobile market participants comparing investment conditions. If their opposition to unfavourable basic conditions remains unsatisfied, they have the option to emigrate.

Emigration entails the relocation of capital for investments and capital gain to a more favourable country and an increased demand for goods and services in this country. Looked at in this way, countries and their institutional regulations (systems) enter into competition with one another.

The core concepts of the new system competition concern its incentive structures and the corresponding effects: in open national economies faced with the rising actual and potential emigration of economic actors,

## Global Competitiveness Index: 2006 and 2005 comparisons

Country/Economy	2006		2005 Rank	Country/Economy	2006		2005 Rank
	Rank	Score			Rank	Score	
Switzerland	1	5.81	4	Azerbaijan	64	4.06	62
Finland	2	5.76	2	Colombia	65	4.04	58
Sweden	3	5.74	7	Brazil	66	4.03	57
Denmark	4	5.70	3	Trinidad and Tobago	67	4.03	66
Singapore	5	5.63	5	Romania	68	4.02	67
United States	6	5.61	1	Argentina	69	4.01	54
Japan	7	5.60	10	Morocco	70	4.01	76
Germany	8	5.58	6	Philippines	71	4.00	73
Netherlands	9	5.56	11	Bulgaria	72	3.96	61
United Kingdom	10	5.54	9	Uruguay	73	3.96	70
Hong Kong SAR	11	5.46	14	Peru	74	3.94	77
Norway	12	5.42	17	Guatemala	75	3.91	95
Taiwan, China	13	5.41	8	Algeria	76	3.90	82
Iceland	14	5.40	16	Vietnam	77	3.89	74
Israel	15	5.38	23	Ukraine	78	3.89	68
Canada	16	5.37	13	Sri Lanka	79	3.87	80
Austria	17	5.32	15	Macedonia, FYR	80	3.86	75
France	18	5.31	12	Botswana	81	3.79	72
Australia	19	5.29	18	Armenia	82	3.75	81
Belgium	20	5.27	20	Dominican Republic	83	3.75	91
Ireland	21	5.21	21	Namibia	84	3.74	79
Luxembourg	22	5.16	24	Georgia	85	3.73	86
New Zealand	23	5.15	22	Moldova	86	3.71	89
Korea, Rep.	24	5.13	19	Serbia and Montenegro	87	3.69	85
Estonia	25	5.12	26	Venezuela	88	3.69	84
Malaysia	26	5.11	25	Bosnia and Herzegovina	89	3.67	88
Chile	27	4.85	27	Ecuador	90	3.67	87
Spain	28	4.77	28	Pakistan	91	3.66	94
Czech Republic	29	4.74	29	Mongolia	92	3.60	90
Tunisia	30	4.71	37	Honduras	93	3.58	97
Barbados	31	4.70	-	Kenya	94	3.57	93
United Arab Emirates	32	4.66	32	Nicaragua	95	3.52	96
Slovenia	33	4.64	30	Tajikistan	96	3.50	92
Portugal	34	4.60	31	Bolivia	97	3.46	101
Thailand	35	4.58	33	Albania	98	3.46	100
Latvia	36	4.57	39	Bangladesh	99	3.46	98
Slovak Republic	37	4.55	36	Suriname	100	3.45	-
Qatar	38	4.55	46	Nigeria	101	3.45	83
Malta	39	4.54	44	Gambia	102	3.43	109
Lithuania	40	4.53	34	Cambodia	103	3.39	111
Hungary	41	4.52	35	Tanzania	104	3.39	105
Italy	42	4.46	38	Benin	105	3.37	106
India	43	4.44	45	Paraguay	106	3.33	102
Kuwait	44	4.41	49	Kyrgyz Republic	107	3.31	104
South Africa	45	4.36	40	Cameroon	108	3.30	99
Cyprus	46	4.36	41	Madagascar	109	3.27	107
Greece	47	4.33	47	Nepal	110	3.26	-
Poland	48	4.30	43	Guyana	111	3.24	108
Bahrain	49	4.28	50	Lesotho	112	3.22	-
Indonesia	50	4.26	69	Uganda	113	3.19	103
Croatia	51	4.26	64	Mauritania	114	3.17	-
Jordan	52	4.25	42	Zambia	115	3.16	-
Costa Rica	53	4.25	56	Burkina Faso	116	3.07	-
China	54	4.24	48	Malawi	117	3.07	114
Mauritius	55	4.20	55	Mali	118	3.02	115
Kazakhstan	56	4.19	51	Zimbabwe	119	3.01	110
Panama	57	4.18	65	Ethiopia	120	2.99	116
Mexico	58	4.18	59	Mozambique	121	2.94	112
Turkey	59	4.14	71	Timor-Leste	122	2.90	113
Jamaica	60	4.10	63	Chad	123	2.61	117
El Salvador	61	4.09	60	Burundi	124	2.59	-
Russian Federation	62	4.08	53	Angola	125	2.50	-
Egypt	63	4.07	52				

Source: World Economic Forum: Global Competitiveness Report 2006-2007

countries are subject to more intense competition. In the long run, they are forced to improve their performance. Methodological individualists hold the view that one is dealing with competition between countries, which are represented by their politicians in the sense that it is ultimately a competition between the politicians in their capacity as representatives of a state.

Institutional improvements can take the form of innovations or, alternatively, imitations of regulations that have worked successfully abroad. The reciprocal service that the mobile market participants of a specific country offer is their non-emigration from the national territory of that country.

The new analytical view of system competition widens both the older model of political competition in democracies by the option of economic drift, as well as the analysis of the public choice theory regarding its effect on political decision-making processes (→*institutional economics*).

The controversy in the critical debate about system competition is mainly whether institutional competition can be seen as analogous to the economic competition in goods markets. It still has to be clarified under which conditions system competition can develop, and whether the danger of the 'race to the bottom' argument actually exists. It also still has to be investigated whether the investors can actually select individual regulations, whether there really is a high degree of mobility, and whether and how the national governments can prevent any threatening drift by collectively harmonising or standardising institutional regulations (→*international migration*).

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Ronald Clapham

### Tax policy

The important aspects of tax policy can be defined by distinguishing between the sources of tax revenue and the different types of taxes, between direct and indirect taxes within the tax structure, between tax load quota and the compulsory charges quota, between tax rate and tax assessment base, and between taxpayer and tax-bearer.

There are currently 46 different types of taxes in Germany. They all draw from only one tax source – the →*income* which the economic agents obtain from the utilisation of factors of production (land, labour, capital). To that extent, any tax is income tax. The fact that there are nevertheless more than 40 ways of absorbing funds from this source is reflected in the five functions of taxation.

- *The fiscal function:* Taxes must be raised economically, with minimal administrative costs.
- *The social function:* The tax burden must be fairly distributed. Instead of the fuzzy concept of justice, economists use the concept of taxation according to the ability to pay.

- *The economic function:* Through taxation, it is possible to discriminate against and weight different kinds of income creation and income use differently.
- *The constitutional function:* The autonomy of regional government authorities in the context of the →*financial constitution* is reinforced by the powers of raising their own taxes.
- *The political function:* The more different types of taxes there are, the less clearly citizens are able to see what exactly the tax burden on their income is. A rational taxation system can fulfil the first four functions with up to 12 types of taxes. The fact that Germany has more than three times as many shows that the tax system is in unequivocal contradiction to the democratic principle; to the principle that the government budget should be based on truth and clarity, and thus on the principles of the →*social market economy*.

The fiscal functions of revenue production and administrative efficiency are fulfilled most effectively by taxing income use, as in the case of the sales tax which was rearranged and became value added tax. This, however, is largely a proportional tax (split tax rates counteract regressive taxation), and thus does not take into account different income-based capacities of taxpayers, which is achieved through the progressive taxation of income emergence, the taxation of wages and income. Proportional taxes are charged at the same percentage for all income categories. Progressive taxation subjects

each progressively higher income category to a higher percentage than the preceding one. This explains the difference between average tax rate (for the entire taxable income) and marginal tax rate (for the next highest income category).

Tax on income emergence is direct tax; tax on income use is indirect. The tax structure indicates the relationship of direct and indirect taxation. Since people should be motivated to earn money rather than to spend it, the economic function of taxation demands that the proportion of indirect taxes must be higher. This also applies in regard to the international location competition.

Comparative international tax surveys have to differentiate between tax quotas and compulsory charges quotas. In different financial constitutions the same government functions are financed in different ways, especially social security benefits, which are financed either through social security contributions or through tax. This is why the financial commitment of citizens is appropriately captured not through the tax quota but through the compulsory charges quota. However, this does not apply – and this has relevance for investment decisions – in the case of company tax.

For the calculation of the overall tax burden, the tax assessment base is just as important as the tax rate. The tax assessment base is dependent on deductions and exceptions, basically any kind of tax concessions (→*subsidies*). The fiscal policy-makers have a choice between high rates and many exceptions or few exceptions and low rates. The more exceptions are made, the

higher the administrative expenses for both government and citizens; transparency is lost, and the number of wrong allocations grows.

Another argument in favour of low tax rates is that there is no linear relationship between tax rate and tax revenue. The higher the tax rate, the more keen taxpayers will be on developing strategies of legal tax avoidance and illegal tax evasion. It follows that increased tax rates can lead to lower tax revenue – and vice versa.

The differentiation between company tax and individual tax is necessary and problematical at the same time. It is necessary because in the case of company taxation, different taxes can add up and thus affect location decisions unfavourably, particularly depending upon the detailed form of corporate tax and local business tax. It is problematical because the (politically influenced) impression exists that the lower income groups are exempt from business taxes.

For a business, taxes equal costs. Either the costs are covered by prices, which are paid by the customers (in which case a tax rollover takes place which sees the customers carrying the taxes), or alternatively, taxes cannot be rolled over on to the prices (in which case the businesses will stop production and reduce their workforce). This shows that a difference has to be made between taxpayers and tax-bearers.

The concept of the 'environment tax' can also send messages which are economically wrong. This can be economically required to internalise external costs through taxation. If, however, such a tax is used to finance running government expenses, it will be a misrepresentation to call it an environmen-

tal tax. Either the tax fulfils its ecological function and brings about behaviour changes such as lower energy consumption (in which case, fewer and fewer government tasks can be financed with the collected revenue), or the fiscal function must be secured and the tax revenue stabilised. This makes it undesirable for the ecological purpose to occur.

A lack of understanding of such economic interconnections makes it possible for the tax policy-makers to mask the function of a specific tax. Right from the start of the Federal Republic, tax policy in Germany has been completely unsystematic and predominantly guided by the political objectives of the day. This has also served to discredit the concept of the →*social market economy*. A successful social market economy therefore requires a tax system which is characterised by:

- the predominant taxation of income use;
- a small number of different types of taxes; and
- low tax rates with few exceptions.

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Wolfgang Reeder

**Third ways: Mixed economy**

The ‘first way’ (→*market economy*) is characterised by personally accountable individuals in the private sector who, on the basis of contractual freedom and the right to private property (→*property*), take responsibility for their decisions. The point of reference of the system is the individual.

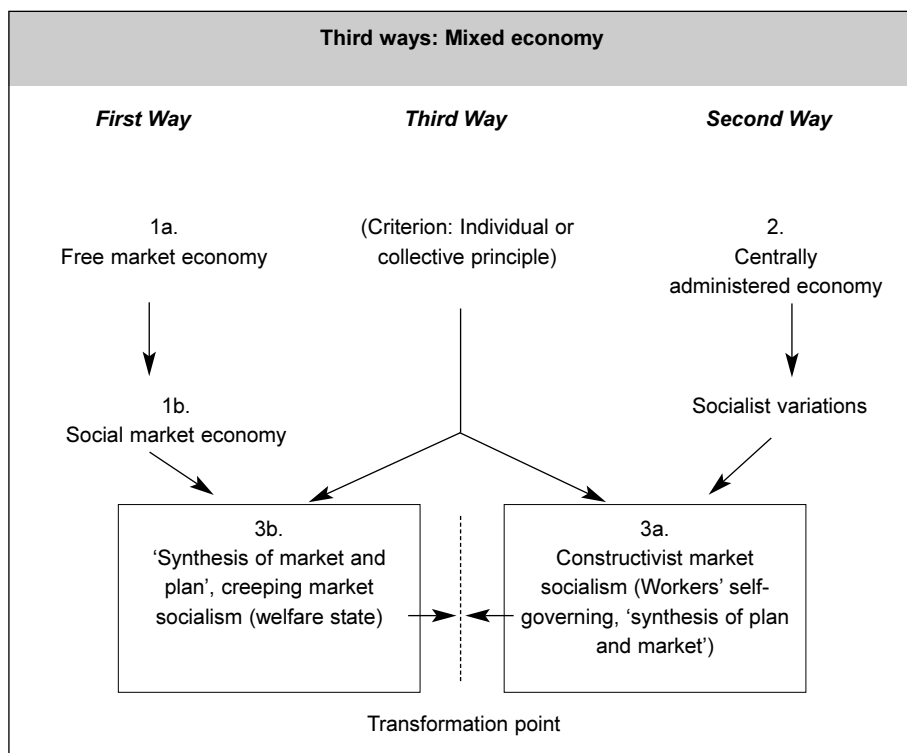
The ‘second way’ – frequently also called a centrally administered economy – decides what (in line with a radical, egalitarian, redistributive state) the citizens, in the context of a socialist political system of orders and apportioning, can and cannot do (→*socialism/planned economy*). Their scope of action has been comprehensively collectivised on the basis of the nationalisation of the means of production and is

systematically used for political aims. The point of reference of the system is the collective.

In between, numerous attempts have been made to turn a mixture of collective and individual principles into the point of reference for a system (hence ‘mixed economy’).

After the Second World War, taking the second way as their point of departure, the Yugoslavians experimented with worker autonomy, and the Czechoslovak Socialist Republic and Hungary with a synthesis of plan and market.

The ‘third way’, also referred to as socialist market economies, relax the collective principle only up to the point where the dominance of social or national ownership of the means of production and the power monopoly of



the Communist Party could be in danger.

The prevailing coordination of this constructivist attempt to mix the collective principle with limited elements of the individual principle has been expressed in politicised, bureaucratic, negotiated solutions (→*constructivism*) averse to responsibility and innovation. To be fair, compared to the rigid order system of the second way, it looked like progress.

Taking the first way as the point of departure, West Germany at the end of the 1960s started to develop ideas on the 'synthesis of market and plan'. These ideas, based on the nationalisation of key areas of the economy, represented a plan of economic control designed to help the collective principle to gain the upper hand by logic, in line with the second way and through the progressive relaxation of the individual principle. It did not come to that, but West Germany subsequently embarked on the third way (by stealth, as it were) via the emergence of the →*welfare state*.

The democratic and Christian socialists saw this as a goal, even as something of intrinsic moral worth, while the Marxist socialists understood it merely as a stop-gap en route to the second way. At the first turn-off into the third way, there are vote-pulling restrictions on the scope of action of private enterprise through the nationalisation of social issues, and justified by the claim to procure maximum equalisation of incomes.

Essential activities of people lose the character of privately organised fields of action and are politicised. Increasingly here, the state seizes the →*income* of individuals in the form of taxes and

social security contributions in order to redistribute them on the basis of political criteria (→*social policy*). Where services and their remuneration in the economy are concerned, the equivalence principle is displaced by the concern for provision.

Typical organisational characteristics of 'market socialism by stealth' are:

- the striving for egalitarian justice, collectives (federations, alliances for ...) as points of reference for the political and economic system;
- a strong dislike of competition and deregulated prices; and
- a far-reaching nationalisation of the social security system.

The resulting modes of behaviour within the society are characterised by a profound lack of responsibility and misdirected incentives, a counter-productive attitude of entitlement by the population towards the state, people continually being ordered around by federations and government authorities, a lasting disappearance of entrepreneurial spirit, a growing loss of authority on the part of the citizens towards the state, and the loss of economic organisation and executive power on the part of the state.

The boundaries between the first and the second ways are blurred. The third way proves to be hollow verbiage, which – as is the case in present-day German social security systems – is either meant to cover up the collectivisation of the right to individual action and planning, or to justify – at best – the lack of acceptance of the first way.

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Alfred Schüller  
Thomas Welsch

### Transport policy

Transport policy includes all measures through which state institutions impact on the transport system of a national economy. The transport system makes it possible for people, goods and messages to traverse distances or to change their locations. Transport policy also includes the requisite means of transport and the necessary infrastructure. Examples of means of transport are road vehicles, trains, aircraft and ships. The transport infrastructure includes the transport routes – roads, the railway system, waterways, stations, airports and signal boxes.

Owing to its strategic importance for the economy and for the prosperity of the entire population, but also to open up and integrate areas and overcome national borders, transport has long been subjected to enormous and extensive government interference. Initially, this interference was politically motivated and served to fulfil the wishes and claims to power of the government (→*interventionism*). Today economic and social criteria are the determining factors of transport policy.

From the macroeconomic point of view, provision has to be made for the mobility needs of a highly developed and internationally ever more strongly

integrated national economy (→*globalisation*), while remaining conscious of the different utility and cost components. The social aspects of a transport policy entail the creation of the most comprehensive network of transport facilities possible for an area (regional component), so that all citizens, independently of →*income* and status, are assured of access to means of transport (personal component). This focus on the common good and the provision for daily necessities usually overrides any profitability criteria.

In the same way as any other policy, a transport policy requires systematic legitimacy beyond mere political declarations of faith. In a democracy based on market economy principles and which relies on the efficiency of the democratic system, market coordination and →*competition*, government interventions can be justified only if the transport markets:

- exhibit functional deficiencies which result in an inefficient and unreliable service for the citizens; and
- despite being in good working order, produce results that do not satisfy the demands of the population.

Transport-related functional deficiencies can be related to infrastructure. Here, it is often the case that one supplier is in a position to supply the entire market more cheaply than several enterprises, so that parallel facilities are not economical. This may, for example, be the case where roads, railways or airports are concerned, and a natural monopoly develops. But if the monopolist has no competition, he can charge



high, uncompetitive prices for inferior quality and discriminate against some clients. In order to prevent this, the monopolist must be subjected to regulations.

Functional deficiencies may also arise if transport activities create expenses borne not by its producers but by non-participant third parties. Such negative external effects are often the consequence of environmental damage, accidents or time delays due to traffic congestion. It is mainly road traffic that is seen as causing this kind of external cost. From the economic point of view, however, the issue is not the abolition of the market; it is, rather, that market prices must incorporate these costs as exactly as possible. Suitable instruments would be regulations, taxes, negotiations between the parties involved or tradable certificates (*→environmental policy*).

Regulations can be used, for example, to enforce environmental protection measures (catalytic converter requirement), whose costs signal to all users that a clean environment has its price. Similarly, taxes may be imposed on environmentally harmful conduct in order to create an incentive to limit the damaging activities. Through negotiations, the party causing harm (such as an airport as a source of noise pollution) and the party being harmed (neighbouring residents) can agree on compensation payments, and at the same time determine the degree of harm that those concerned are prepared to tolerate. Tradable certificates are a limited number of damage permits that may be traded in the market and each of which specifies an exact quantity of pollutants (such as carbon dioxide). Only those in possession of these certificates are

allowed to emit pollutants, so that an incentive exists to pollute less and thus to save the money for certificates.

Since the application of these instruments equally costs money – it is true that the introduction of an environmental tax on petrol reduced the traffic volume and thus the environmental impact – it also raises the price that has to be paid for mobility. One therefore has to investigate in detail the extent to which people are prepared to carry damage-avoidance costs. But it also has to be considered that the exact repercussions of transport are not yet known, and environmental damage also has numerous other causes.

In principle, individuals may end up in a situation where they or members of their families lack the financial means to use transport at market prices. But since without mobility it is difficult to participate in economic and social activities, one may find that there is broad consensus on offering such persons the chance to be mobile.

Instruments that would achieve this could be a public supply of transport services below cost – for example, for local public passenger services or the appointment of private suppliers to do the job, with the government covering the cost or providing direct financial aid for needy persons (*→subsidies, government assistance*).

The familiar drawbacks of government involvement in business activities – too much bureaucracy, lacking cost awareness, insufficient inclination to innovate – suggest either that needy persons should receive direct financial aid in order to use the privately supplied transport services of their choice, or that private suppliers should be

recruited through official tenders to provide services for these groups.

The consideration of these principles – and the experiences in other countries (→*EU: transport policy*) – has led to a transport policy that is now more strongly oriented towards free market principles. The exaggerated quantity and tariff regulations for road haulage, air transport and inland navigation were abolished in the 1990s, paving the way for more market-related reforms of the state's German railway enterprise, the →*privatisation* of airports and the provision and maintenance of road infrastructure. There is nevertheless still a substantial need for deregulation and privatisation, particularly in the railways and public local passenger services. This is the only way of achieving an efficient transport policy that is free of individual interests and that serves the well-being of all citizens.

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*Karl-Hans Hartwig*

### ***Treuhand Privatisation Agency*** **(*Treuhandanstalt*)**

The *Treuhand* was the name of the national privatisation organisation set up during the transformation of East Germany from a planned to a →*market*

*economy*. The Treuhand Privatisation Agency (*Treuhandanstalt*) was established in 1990 and continued in reduced form from 1995 as the Federal Institute for Special Tasks Arising from Unification, and was dissolved almost completely in 2000.

The idea for its establishment came from the Citizens' Movement of the GDR at the time, and from the reform-communist Modrow government. Initially, the *Treuhand* was merely supposed to administer the enterprises that had been transferred to it in order to prevent spontaneous →*privatisation* and to keep open a possible →*third way*. The election of the democratic de Maizière government in March 1990 and the subsequent reunification under the Kohl government meant that the *Treuhand* was given a new project: the privatisation of the East German economy. This was an enormous task because 4.2 million workers were employed in *Treuhand* enterprises. The *Treuhand* had become the owner of nearly all large-scale enterprises (com-bines) and of more than a quarter of the hotels, restaurants and shops in East Germany. Almost one-third of the fields and arable land and two-thirds of the forests had become its property, and there was also a good deal of real estate.

During the privatisation process, the *Treuhand* had to take the claims of other owners into account, both from national institutions (communalisation) and from private persons whose property had been expropriated (re-privatisation). The privatisation of the banks and insurance companies as well as the monopolies in the power, gas, transport and water sectors were special cases. Here the *Treuhand* was officially

involved, but the actual decisions were taken by the responsible ministries or the government.

The *Treuhand* was an agency of public law – or a semi-independent authority – which reported to the Federal Ministry of Finance. It was organised in the same way as a public limited company. The board of directors (the supervisory board) was made up of representatives of the federal government, the East German states, as well as representatives of the important employers' associations and trade unions. Experienced →*entrepreneurs* and economists were invited on to the board and the executive committee. The most important presidents (chairmen of the managing board) of the *Treuhand* were Detlev Rohwedder (1990–1991), who was the victim of a political assassination, and Birgit Breuel (1991–1994).

Large enterprises were privatised by the Berlin head office and smaller enterprises through the 15 branches. Real estate was sold through the *Treuhand* Real Estate Company and land was sold through the Land Utilisation and Management Company. Initially, the *Treuhand* had a staff of only about 300, but during peak periods this increased to 3,000.

The *Treuhand* carried out its privatisations by converting state enterprises into private companies (plc's, limited companies) and by dividing large-scale enterprises into 14,000 smaller enterprises and selling them. However, these were no normal company sales, since many of these businesses were on the verge of bankruptcy, and the buyers were expected to fulfil special conditions. The *Treuhand* did not therefore auction its enterprises at the highest

price; rather, it demanded commitments to jobs and investments, which had to be supported by detailed business plans. Many potential buyers, especially from abroad, were put off by these conditions. In response, the *Treuhand* reduced purchase prices, partly restructured the enterprises or offered →*subsidies*. By the end of 1994, most of the enterprises had been sold or closed down. When Schröder's government came to power in 1998, there was nothing left to do except privatise the remaining real estate and land as well as monitor long-term privatisation contracts.

The *Treuhand* was a →*parastatal*. Its expenses amounted to over €155 billion while its income was less than €40 billion. The high expenses were due to old company liabilities, the removal of environmentally dangerous refuse dumps and the restructuring of enterprises. The small returns were mainly the result of the low value of the enterprises and price reductions in return for employment and investment promises. Debts to the value of just under €107 billion were transferred to the →*Redemption Fund for Inherited Liabilities*. The remaining debts were covered by the federal government's annual budgets.

The *Treuhand* was subject to constant criticism. Some of the critics demanded that it should privatise more slowly, that it should first restructure the enterprises and preserve an industrial heartland, or that it should become the Ministry for Reconstruction East in order to save as many jobs as possible. Other critics demanded exactly the opposite on the grounds that a slower privatisation process would be even more expensive and that the *Treuhand*

was no better an entrepreneur than the private buyers. It became clear that the *Treuhand* was not an independent authority whose sole purpose was carrying out privatisations. It was subject to considerable political pressure from the federal and state governments as well as →*interest groups* and the public, and it got caught up in the →*conflicting aims in economic policy*. Basically, it was the rule that the larger and the more decrepit the enterprise, the greater the political pressure to embark on an expensive restructuring process. It was also criticised that the *Treuhand* did not participate in wage negotiations for its enterprises. Particularly between 1990 and 1991 it should have advocated slower wage adaptation in East Germany (→*Reunification: monetary, economic and social union*).

However, the *Treuhand* did its job, which was mass privatisation in East Germany. This did not happen automatically, as the experiences of other transition countries demonstrate. The result is that on the one hand the majority of enterprises in East Germany are now private and have the potential for further economic growth. On the other hand, however, the privatisation process was not efficient.

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Uwe Siegmund

## Types of market economy

The constituent elements of economic and social systems are the ‘place of decision-making’ – decentralised (→*enterprises* and households) or centralised – and the ‘type of property’ – private or collective property. If we combine these elements, a matrix results (*see matrix*).

It must be remembered that a socialist market economy and a capitalist centrally administered economy are either only mental constructs or transient phenomena (e.g. in times of war), which with the passage of time will lean towards either the one basic type or the other.

Thus, in real life, there are principally only two basic types: →*market economy* or centrally administered economy. They were considered stable; but now this statement has to be modified to relatively stable considering the fact that socialist societies have collapsed. In the case of Cuba, North Korea and China, one has to ask for how much longer their →*socialism* can survive.

If, while actual socialism was still a reality, it used to be permitted to classify economic and social systems as either ‘market economies’ or ‘centrally administered economies’, then today the different types of market economies have to be considered. Here, too, we are simplifying if we distinguish four types:

- market economies without state interventions;
- market economies with state interventions;
- market economies with overlapping state and private spheres of influence;

- formerly socialist economies which are becoming market economies – or so-called transition countries.

Taking these forms further:

- The United States is considered to be a market economy without state intervention (→*interventionism*). The economy is controlled almost exclusively by prices and profits. State involvement is concentrated on infrastructure and basic conditions; private initiative is given broad scope. The society rests on the principles of individualism. At the same time, innovative drive and dynamism are strongly pronounced. If a person cannot, and also is not supposed to, rely on the community, then the motivation for helping oneself is strengthened. However, what about those who are either unable or barely able to do this? Even if such a society is not necessarily anti-social, one can still agree with the Nobel laureate Robert Solow: 'My own country is doing rather well, as far as the "market part" is concerned, and badly, concerning the "social part".' In

Germany today, one might say the opposite is the case. The question is whether it is possible to do equal justice to both aspects?'

- It is the goal of the →*social market economy* 'to connect a competitive economy which invites free initiative, with social progress, secured by a productive market economy' (Alfred →*Müller-Armack*). An economic policy programme aimed at 'prosperity for all' (Ludwig →*Erhard*) was supposed to create a situation where citizens are less and less dependent on the state welfare service. The political →*competition*, however, meant that with growing prosperity and rising tax revenues the social system continued to be perfected and expanded. The →*social state* deviated from the path the people had been promised. The bureaucracy which grew out of it is channelling the political control over other peoples' incomes into the hands of a few: this goes against the ideas of liberty and equality, for which the →*political parties* originally wanted to fight. The reality of the social market economy is therefore to

Types of market economy matrix		
Decision Property	Decentralised	Centralised
Private	Capitalist market economy	Capitalist centrally administered economy
Collective	Socialist market economy	Socialist centrally administered economy

be revitalised in the sense of Ludwig Erhard and Alfred Müller-Armack. When she was chief whip of the Christian Democratic Union (CDU), Chancellor Angela Merkel declared that she wanted to find a new balance between demands and the ability and/or will to be productive in the 'us-society'.

- Ten years ago or more, Japan and Southeast Asia were still regarded as future models for the European nations, due to the assumption that the overlap of state and private sector strengthens both the state (because it can be sure of the economic strength of its enterprises) and the enterprises (because their competitors in the respective markets would not only be dealing with an individual enterprise but with the 'System Japan' or 'Japan Inc.'). It is this very amalgamation that is now considered a problem for Japan and some Southeast Asian states since it has caused areas of responsibility to become blurred and the principle of liability to be passed over, at least to a large extent. This is why these countries are generally advised to adopt a process of →*deregulation*, which basically entails a retreat of the state from those areas where it used to have a controlling effect on private economic activities. The difficulties of deregulation are on one hand rooted in the traditions of these countries, which have always regarded standing up for one another as propitious – the virtue of loyalty – and on the other hand they are linked to the costs associated with such a change. The weaker the economy, the more acutely painful these difficulties will be.

- Countries that after the failure of socialism have to introduce a free market system, not only have to establish free market procedures in the different areas but also have to create the foundation for a private legal system. After 40 years of socialism, only a political Hercules can clear these Augean Stables of perks, privileges and corruption. Experiential reports show that this is precisely where the biggest problems lie. The opportunities to make a new start, too, are unequal and unfairly distributed for many. The type of person who feels most at ease in the twilight zone between a market economy and state intervention is the one who is almost completely without scruples towards his/her fellow citizens. The market economy, which is perceived as cold and inhuman, is then blamed for the money-making methods and exploitation used. Many people who used to be persistently and deeply sceptical about socialist systems will often say today that the socialist leaders 'always betrayed and deceived us' but that only in one respect did they tell the truth: 'Capitalism exactly resembles the picture they showed us.'

In the course of →*globalisation*, the features of the different market economies will become assimilated, but differences will always remain due to, for instance, mentality or tradition. National governments are not, as widely believed, hopelessly at the mercy of the globalisation process, but it challenges them to adhere to good governance. Just as ships can tackle a stiff breeze by setting their sails skilfully, so states can adjust to globalisation by modifying their systems of governance wisely.

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Joachim Starbatty

### Unemployment: Causes and effects

No one should be personally blamed for being unemployed. The problem of unemployment cannot be properly understood and solved unless all the contributing factors are taken into account. Unemployment is the result of extremely complex cause-effect relationships involving people, the institutional framework of the state, markets, and society and its organisation. Historically, the development of these cause-effect relationships has led to prosperity levels previously inconceivable in the world. Unemployment is a sign of poor organisation of the main contributing factors and processes. A solution to the problem of unemployment therefore requires an analysis of some shortcomings.

#### *Job markets and occupation*

It is true to say that in advanced industrialised societies the world over, and equally in Germany, a system of organised work has developed, albeit in different forms, that in terms of economic efficiency far exceeds all past modes of production.

This system of organised work is indeed committed to free market prin-

ciples: the labour law currently in force makes provision for free working conditions. For the purpose of increased prosperity for all, it relies on the successes of a system of decentralised planning. Nevertheless, labour law has to be seen in the context of its place within a constitution that grants freedom of association as a fundamental right.

The organisation of workers and employers in associations is voluntary (trade unions and employers' associations), but their collective agreements and union contracts affect conditions in the workplace and the economic conditions as a whole (→*collective agreements*).

The organisational element in the area of labour law is manifested in the right to form associations, the right to enter into collective agreements, the right to engage in →*industrial action*, as well as →*industrial relations* and the right to →*co-determination*. The intention is to guarantee →*social justice* in a system of markets where the supremacy of one commercial interest group is generally to be avoided. The most important argument in favour of collective worker representation through trade union is the assumption that otherwise a power imbalance between workers and employers would develop (labour market regulations).

What characterises a free market system is decentralised planning. This means that a variety of production units (businesses), independently and at their own risk, make plans to satisfy the needs of the buyer (customer) by means of specific product and service offers. In order to be able to make these offers, they have to enter into contractual relationships with the requisite factors of production. It is on the basis of

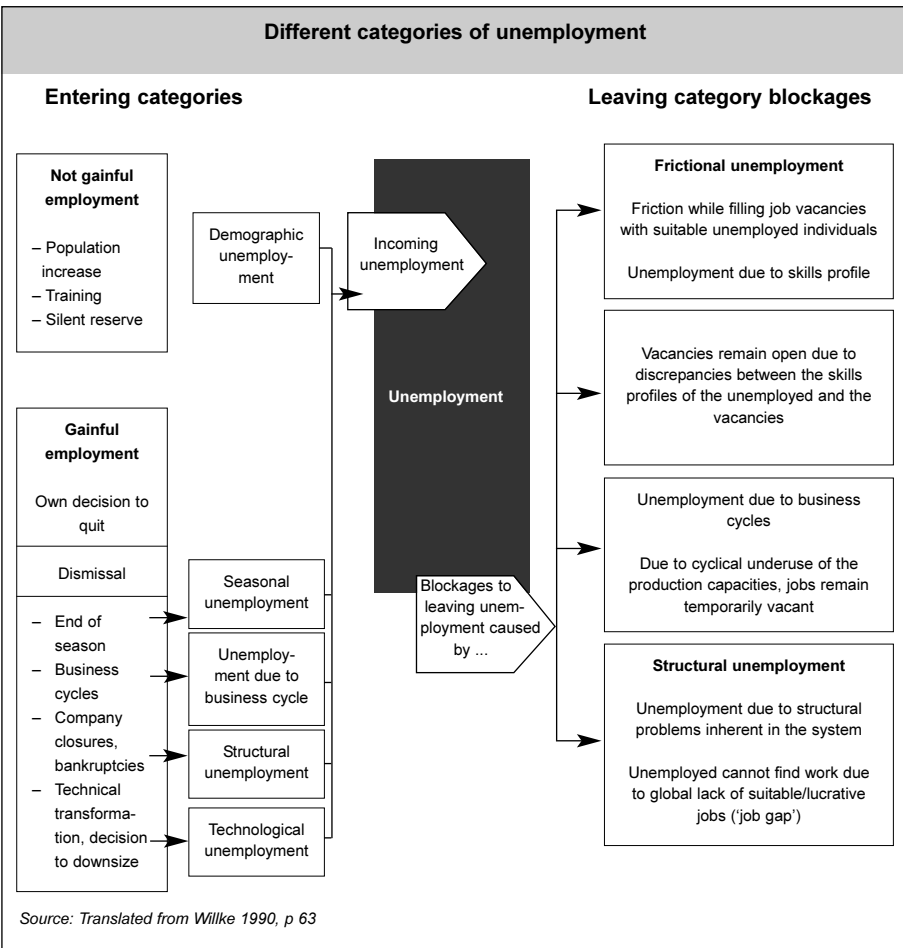
this system of advanced division of labour that businesses can offer steady employment.

A worker, by accepting a job offer and more especially by actually starting work, enters into an employment relationship based on statutes laid down in the employment contract and which are legally binding for both employer and employee.

The performance requirements which an employee has to satisfy – apart from special professional qualifications – include a high degree of punctuality, accuracy and precision in the execution

of tasks, responsibility in dealings with materials and humans and, added to this, the social skills needed to get on well with the other people in the workplace and to achieve a cooperative way of working. Such competences are indispensable for the organisation of economically efficient operational processes in →enterprises.

The business itself forms the basis for the salaries payable to the staff. These salaries are negotiated on the labour market; their levels depend on evaluations of both the type of work involved and the worker's perform-





ance. They are by far the largest source of →*revenues* in the national economy.

***Competition as the catalyst for prosperity and changes in the labour market***

Free market economies rely on the dynamics of →*competition* for increased prosperity. New products, procedures, markets and organisational structures bring with them irreversibly altered modes of production and acquisition, leading to a changed structure of work for gain. At times when the respective volumes of dismissals and reinstatements of workers are equal – this generally only happens during periods of rapid growth of the national product – the awareness of the fact that extremely sensitive and complicated market processes are at work tends to wane. In the job markets, the dynamics of these processes manifest themselves above all in the number of people per year opting for a change of occupation.

According to the occupational statistics of the →*Federal Employment Agency*, the employment circumstances of nearly one-third of the work force changed in 1998. That means that within a three-year period the structure of the economy undergoes an almost complete transformation. What this may look like in detail can be illustrated with the help of data extracted from job market investigations during the 1970s and 1980s: with a total volume of about 26–27 million jobs, 10–12 million new occupations were taking place annually. Three to four million of these consisted of entry and exit mobility (which represented 12–15% of all jobs), while about 2.5 million represented inter-company movements (or approximately one-fifth of all job changes); in-house transfers

reached a total volume of about 4–5 million. In view of these dynamics and the fact that their actual details cannot be foreseen, it must be assumed that there will always be a certain amount of involuntary unemployment.

***On the typology of unemployment***

In order to understand the causes of the emergence of unemployment, it will be most helpful to refer back to this constant movement of market processes. This opens the view on to a typology of unemployment. In this regard, the most important question is: What is blocking an easy transition from an unemployed to an employed state, so desirable to everyone who is involuntarily unemployed? One thus asks particularly for the facts, which after a dismissal can delay a brisk reintegration into gainful employment. The figure opposite illustrates the potential barriers preventing access to gainful employment, causing certain people to remain unemployed.

On analysing this figure, the first conclusion is that there are times when a state of nearly full employment (→*employment*) cannot be achieved because overall demand in the economy is too low. This is essentially determined by consumers and investors and their future expectations, and also by the way private and public households manage their budgets, both at home and abroad.

Second, however, one has to bear in mind that demand can fluctuate for such different reasons as seasonal or structural changes or because of business cycles.

Third, some of the typical characteristics of the phenomenon of unem-

<b>Distribution of unemployment by different groups in Germany, 1995–2005</b>						
	<b>1995</b>		<b>2000</b>		<b>2005</b>	
	<b>%</b>	<b>x 1,000</b>	<b>%</b>	<b>x 1,000</b>	<b>%</b>	<b>x 1,000</b>
Total number of unemployed	100.0	3,521	100.0	3,684	100.0	3,989
<i>Of these:</i>						
Male	50.1	1,764	51.5	1,899	52.4	2,089
Female	49.9	1,756	48.5	1,786	47.7	1,901
Foreigners	n.a.	n.a.	11.9	440	15.1	604
Germans	n.a.	n.a.	88.1	3,245	84.9	3,385
With health problems	22.7	798	26.1	963	22.1	881
<i>Of these: severely disabled</i>	4.9	173	4.9	179	4.1	165
Permanently unemployed persons (>1 year)	31.9	1,125	36.4	1,343	37.4	1,492
With completed professional education	61.0	2,147	62.2	2,290	59.7	2,382
Without completed professional education	39.0	1,374	37.8	1,395	40.3	1,608
Elderly people (age in years)						
55–59	18.2	641	17.2	635	10.6	421
60–64	2.8	100	4.3	158	1.6	63

*Source: Federal Labour Agency: Structure Analysis*

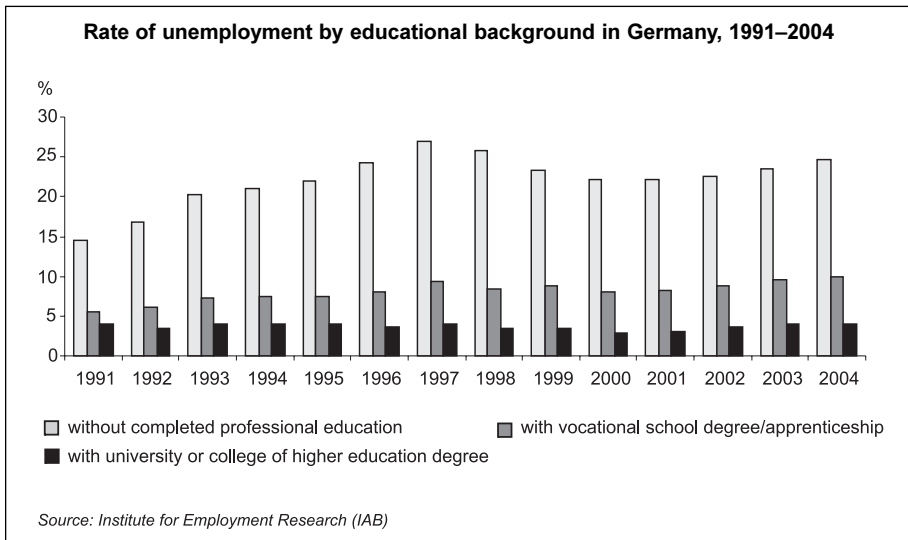
ployment arise from inflexibilities in the development and structuring of wages, which in turn are consequences of collective agreements. Furthermore, certain government decisions in the sector of fiscal, taxation and competition policies have a negative effect on employment. Appraisals for Germany up to 1998 indicate that mistakes in this third area may have contributed about 8% to the unemployment rate.

Fourth, empirical research has grappled with the additional question of the extent to which individual, i.e. personal characteristics, may make it difficult for job-seekers to find employment. The figure illustrates the sorts of hurdles present in the job market in Germany.

Apart from the question of how effective employment agencies can actually be, this diagram highlights the problem of long-term unemployment

(unemployed for one year and longer) as a consequence of the combination of several factors which make successful outcomes difficult for the agencies. One of these is the duration of unemployment already existing. Brisk re-employment is therefore a priority. If this fails due to high adjustment hurdles, for example wage levels being too high and rigid due to the wage systems (a phenomenon which has been observed since 1997), there is a danger that long-term unemployment will rise despite an overall downward trend.

On the one hand, this proves the importance of making systematic distinctions between the causes of unemployment, since these are what determine the choice of economic policy measures to combat them. On the other hand, it is obvious that this distinction alone does not suffice: complex



cause-effect relationships that come into play in each individual case must also be taken into account. If the diagnosis ignores the potential multiplicity of causative factors, the treatment is doomed to failure. Unfortunately, everyday politics is all too often lacking in sufficiently differentiated analysis.

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*Hans-Günter Krüsselberg*

### Unemployment: Social security

The United Nations General Declaration of Human Rights (1948) considers the creation of a world free of fear and

misery as the common ideal to be attained by all peoples and nations. Article 22 reads: 'Every human being as a member of society has the right to social security'. Article 23 states that every human being has the right to work, to free choice of occupation, to adequate and satisfactory working conditions as well as to protection against unemployment; and, under the heading social support, special reference is made in Article 25 to security in the event of unemployment.

In the context of the social, economic and financial policies of the German federal government, the Employment Promotion Act (1969; amended several times) is meant to promote balance in the labour market, taking into account the social, economic and finance policies implemented by government.

The most recent amendment specifically concedes that the original idea – sustained by the euphoria of post-Keynesian thinking on employment (→*Keynesianism*) – that govern-

ment can guarantee full employment ( $\rightarrow$ employment), and at the same time also stimulate economic growth, represents an over-estimation of the actual possibilities of economic policy. For these reasons, particular emphasis is to be put on the supportive role of work promotion in the future; it is supposed to facilitate access to the regular job market and to be more strongly focused on actively helpful job centres.

Work promotion entails measures for the prevention of unemployment as well as assistance in cases of unemployment that already exist. The latter should achieve the integration or re-integration of the unemployed person into working life as quickly as possible. The legislation still accords priority to avoiding unemployment, for example via job procurement by training, to security in the event of unemployment by means of the payment of wage replacement grants (such as unemployment benefits, unemployment aid) to potential wage-earners in times of involuntary unemployment.

And yet the legitimate need to allocate money to persons who due to unemployment are unable to support themselves adequately, has to be justified. Here, the legislator takes the following stance: the dynamism of a competitive economy generally boosts economic and social prosperity. If, however, this dynamism leads to involuntary unemployment for certain individuals, society owes them wage replacement and assistance in the search for a new job of equal or ideally higher value.

### ***The labour promotion laws and the need for reform***

In legal terms, workers are unemployed

if they: are temporarily not in an employment relationship, or are looking for a job, making them liable for social security contributions; are open to the attempts by the labour office to find an acceptable position; and are registered as unemployed at a labour office. In this case, those concerned (provided they meet certain criteria) become eligible for unemployment benefit, graduated over time and depending both on their age and on the length of time spent in an occupation with compulsory insurance contributions.

Younger employees can become eligible for unemployment benefits for a maximum of one year. Unemployment relief is granted when a person is no longer eligible for unemployment pay, if special conditions are met during a previous employment relationship that present grounds for such claims, and if hardship in the sense of destitution exists. In principle, unemployment relief is granted for an unlimited period, but only until reaching retirement age.

Within the framework of the social security system, public social security assistance is supposed to close the gaps left by other social security benefit schemes. Its task is to enable the beneficiaries to live with dignity and enjoy the minimum socio-cultural standard of living that can be expected in Germany.

The social security assistance forms a universal safety net for people who are in financial trouble, meaning that they are not able to support themselves by their own efforts, and to which all needy citizens are legally entitled. Government assistance is supposed to offer all welfare beneficiaries the oppor-

tunity to reintegrate themselves into the general working life of the community. Citizens are expected to participate in this effort to the best of their ability.

Compared to 1980 when only about 10% of the then scarcely 1.3 million people on the social assistance roll were unemployed, their proportion rose to 40% in 1998, with 2.9 million people on social assistance. The considerable extent of long-term unemployment must be regarded as one of the main reasons for the almost explosive expansion of the volume of social assistance grants in Germany. The fact that all citizens are entitled to support grants equivalent to the social assistance requirements, means that in all cases where the unemployment assistance or unemployment pay does not reach this level the difference has to be made up by social assistance. Actual case studies for the year 1997 singled out that above all, unemployed heads of families with low skill received, thanks to the complementary social assistance, amounts which added up to no less than 93% of their earlier disposable labour income.

The political conclusion to be drawn from this is that the German social security assistance system is now torn between its role as a provider of social benefits and the question of how to motivate unemployed people to find new jobs or to improve their professional qualifications. At both the theoretical and practical levels, the concept of a politically created 'dependency trap' is frequently talked about. Reforms have been suggested that carry a financial reward for the unemployed who make the effort to find work. Each of these reform proposals is essentially focused on a workable combination of

benefits that support job-seekers in their search for gainful employment, while at the same time obviating cases of social hardship.

The manner in which the various responsibilities are assigned is clearly of great importance. One must never forget that for a long time the self-help organisations which sprang up in the course of industrialisation in the form of trade associations and trade unions were regarded as the most suitable providers of unemployment insurance, particularly if the public sector is in a position to provide some of the finance. Indeed, this approach has been revisited as one of the reform proposals. At the same time, special attention should be paid to proposals that plan to allocate the responsibility for active employment policy to the municipalities, while wanting assurances that they can attract sufficient funds from the vertical financial equalisation scheme (→*fiscal federalism*). Without reforms, which need to be properly conceptualised and must be tried and tested, it will hardly be possible to solve the current labour dilemma, but reforms are nevertheless necessary.

### ***Unemployment – the individual and the family perspective***

The effect of unemployment on the situation of individuals and families is discussed in detail in the *Fifth Family Report* (1994). There, the serious consequences of unemployment for both single people and families are highlighted, while at the same time it is made clear that the actual state of information on individual experiences is extremely unsatisfactory. The long-term effects of unemployment include:

- inclination to social isolation and disintegration;
- potential identity crisis leading to the risk of suicide;
- loss of work orientation and motivation;
- loss of the awareness of time; and
- the incidence of psychosomatic illnesses.

Yet it is equally important to consider case histories in the context of a family situation, taking into account the shared coping potential and stabilising force that the family may offer in times of crisis. However, families are also at risk of being confronted with the threat of educational difficulties affecting the children, a growing number of children with special needs and suffering from neglect, or showing no interest in further education or training out of indifference towards their own future.

Specialist literature constantly stresses that unemployment is an entirely historical phenomenon – particularly due to the coping mechanisms available to affected individuals within their social peer groups. But simplistic conclusions are not acceptable. The way a person deals with unemployment strongly depends on that person's attitude towards social security services and the way these are utilised, as well as on fundamental notions about the value systems of the world of work. Empirical research developed the thesis that gainfully employed people in Germany had learned to integrate employment interruptions into their lives. Interruptions

to gainful employment would under such circumstances no longer be experienced as disastrous events that are inevitably afflicted with the stigma of material and psychological poverty. Should this assumption be correct, the 'de-dramatisation' intended by the legislator might, at least in the case of transitional unemployment, mean that certain individuals can actually accept their unemployed state. A basic prerequisite for the implementation of such social stabilisation processes would be economic, financial and labour market policies of visible reliability.

Regardless of anything else, the way out of unemployment requires individuals to have resources at their disposal and to possess the drive for action that makes the adequate participation in all social processes possible, and is today rightly referred to as human capital. This capability, coupled with the opportunity to access the active use of other variants of capital, attainable above all through the (promotion of) wealth accumulation for workers, must be more strongly and imaginatively supported than ever before and with the use of all conceivable means.

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## Vocational training and further education

In contrast to general education (schools for general education), vocational education is aimed at either the acquisition of special knowledge and skills pertaining to a particular occupation (training), or at gaining additional qualifications (further training).

As opposed to other countries such as the United Kingdom, vocational training in Germany is comprehensive and designed as a vocational unit and not module-based or exclusively focused on a certain subject. It takes the form of a dual training course with its practical part on the shop floor and the theoretical part at a vocational college, usually lasting 2.5 to 3.5 years.

The definition of a profession (career profile) is contained in professional training directives, which on the basis of the Occupational Training Law (a federal law, unlike the school laws which are state laws) are formulated by the parties to a collective agreement, with expert advice, before being declared legally valid by the state. The job requirements of the employers flow directly into this in such a way that they have general validity and do not only apply to individual businesses, but are officially recognised as requirements in the labour market. Some 365 occupations have been defined in this way.

The German training system – unlike the German schools and universities – enjoys a good reputation abroad. The main reason for this is the keen interest of the training companies and →enterprises to produce the best qualified new staff members possible: since the largest part of the training takes

place on the shop floor (operational training) and has to be funded by the individual companies, company commitment to appropriate, quality training is very strong. It is clearly stronger than that of a public school or university would be, where it makes no difference whether the training of pupils and students is successful or not.

Vocational training is conditional upon a training contract, which has to be signed by the trainee and the company. The problem is that such contracts are signed on a voluntary basis, and a company or a national administration will sign only if they need trainees and suitable candidates are available. Often, the vocational ideas of the trainees and the training requirements of the economy do not coincide. Companies also tend to delay training if long-term business prospects are not good. It must also be remembered that some years have a high and others a low birth rate and that, accordingly, there will either be excess demand or a demand deficit (surplus supply) of training vacancies. This is why not everybody who is looking for a training vacancy may find one or, alternatively, why not all training vacancies are taken up. The latter may even occur if a number of those looking for a training vacancy are unsuccessful and become unemployed, because they have not been able to fulfil the requirements or because the training vacancies which they were looking for (regional or vocational) were not compatible with those that were available.

In order to avoid the situation where young people cannot find a training vacancy and in order to offer a greater variety of such places, the idea of financing them by contributions has

been repeatedly considered. Such a contribution is supposed to be levied on all companies employing trained workers. Such fees should be deposited into a fund, from which training places are eventually financed.

Most of these suggestions come from the employees and are made with the proviso that the companies actually doing the training are exempt from the levy – to the extent of their actual training expenses. But this presupposes the calculation of the costs of such training posts, so that they can be deducted from the contribution paid. This causes administrative expenses and results in the management of the fund imposing stringent cost registration regulations and additional training regulations on the companies. This restricts the companies' scope of action and removes more and more responsibility from them. The system that keeps training in tune with the requirements of the labour market will be undermined. These are some of the reasons why the employers' side has so far not agreed to this option.

The efficiency of the German dual system of professional training is actually based on the principle of individual funding by companies (→*education funding*). It gives companies the incentive to assess training requirements carefully and to offer quality training.

The best way of overcoming the drawbacks of vocational training funded by individual companies is to achieve a balance between the →*supply and demand* of training posts. This can be done by means of either reducing costs (adjustment of trainee remuneration), or increasing trainee productivity to compensate for company expenditure on training. In addition, in a →*social*

*market economy* the government can give educational grants (training subsidies) and tax concessions.

In contrast to company training, professional further education is not legally regulated. However, in the age of the knowledge society and lifelong learning it plays an ever more important role (→*education and research policy*). Here, the individuals will have to accept more responsibility for their qualifications in order to be professionally flexible and to reduce the risk of →*unemployment*. This means that more transparency and more consultation with competent executives and experts will be needed. This is intended as a contractual requirement in some employment agreements and more recently, in isolated cases, even in →*collective agreements*.

It also presupposes that individuals should be prepared to use the study leave to which they are entitled in some states of Germany for further training, and if necessary sacrifice spare time as well as contribute to the training costs. The latter is required if the vocational further training is to be useful to the individual but not to the present employer. Besides that, in the context of active →*labour market policy*, the →*Federal Employment Agency* assists workers to gain further training, re-training and training on the job, in order to prevent their becoming unemployed from the start. Distance learning, the internet and the employment of new technologies open up further cost-effective vocational further training options.

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Ulrich van Lith

### Wealth accumulation policy

Freedom,  $\rightarrow$ *individual responsibility* and social obligation are basic pillars of society and economy in the  $\rightarrow$ *social market economy*. Private  $\rightarrow$ *property* of net assets is one of the expressions of these basic principles. Those who own capital have more scope to be free agents than those who have none. The accumulation of assets for the purpose of making provisions privately (such as in the form of insurance, privately owned residential property, bonds) is a practical expression of personal responsibility and social duty (in order not to be a burden on the community).

Private ownership of capital as a factor of production is subject to the same basic principles. Although the social obligation that private capital often includes is frequently overlooked, a market economy based on competitive principles will largely take care of it. People who make capital available to the production process under these conditions – by managing a private business, by buying shares or, indirectly, through a savings account (and the granting of credit by the banks) – are usually motivated by profit or interest. In a situation where there is healthy  $\rightarrow$ *competition*, they are unconsciously fulfilling an important social function

by channelling capital into the production of goods and services which constitute, safeguard and increase the prosperity of the entire population by technical progress.

Under competitive conditions, a  $\rightarrow$ *market economy* is usually social of its own accord. Thus the social market economy is not given the attribute social only because it is complemented by a comprehensive social security system (such as  $\rightarrow$ *old age pension*,  $\rightarrow$ *health insurance* or the  $\rightarrow$ *basic social security* system), income redistribution (progressive income tax) and public goods (schools, the judiciary), but because in the context of a workable competitive market the selfish motives of individual people (the profit and income motive) turn into behaviour with social (prosperity promoting) consequences. The government through its competition policy has to provide an appropriate basic framework.

This explains why in a social market economy the government uses various methods of assisting its citizens in accumulating capital and aims at a broad distribution of private wealth. This ranges from the promotion of savings through building societies and securities to worker participation in companies, and the provision for risk and old age through life assurance policies. If, despite offers of support, large sectors of the population are not doing enough, or cannot do enough, to build up capital assets (such as in the provision for old age, in the health insurance protection, but also in the formation of their personal human capital), legal force is used (mandatory social security systems, compulsory schooling).

A variety of effects result from capi-

tal formation. Through savings, new wealth is created, and financial capital is usually invested in material capital (investments). More capital increases the productivity of the economy and thus the real income of households. Broader distribution of capital – insofar as it succeeds – is an independent goal, but it also levels out income distribution. However, capital distribution (most easily perhaps through a greater spread of residential property) and income distribution are difficult to manipulate through politics.

Making provision for the future means reducing financial uncertainty. However, the different forms (private assets, private insurance, social security, also one's own training and children) have different pros and cons. Thus while social security reduces individual uncertainty, it generally does not form capital – as it is pay-as-you-go based – and it thus contributes little to the accumulation of assets and to economic growth. Future risks can be reduced through diversification: the greatest possible variety of different forms (contribution-funded social security, insurance policies based on capital, financial assets such as bank deposits, and material assets such as residential property) is therefore an advantage. Since pay-as-you-go based social security (e.g. pension, health and nursing care insurance schemes) is at risk due to →*demographic development*, a political attempt is now under way to supplement this through the promotion of private savings schemes (i.e. private savings for old age) and various capital accumulating systems.

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Eckhard Knappe

## World trade order

The world trade order covers all the commercial rules and institutions for the promotion of the international exchange of material goods, based on intergovernmental agreements and services, for the benefit of all countries involved. Whether and how this can be achieved depends on the global network of the economic systems. This network and how it functions has a significant impact on the production and employment situation in the different sectors (the export sectors and industries exposed to competitive imports), on income levels and on growth trends in the trading partners worldwide.

International trade rules that form the basic regulatory framework for the free global exchange of goods and for international →*competition*, intensify international competition and cause the global goods markets to become more closely interdependent. The opening-up of national markets and internation-

al trade regulations are important aspects of the ongoing process of globalisation.

This is also the case regarding the increasing internationalisation of production processes (where the manufacture of components and the final assembly of a product take place in different countries), greater international mobility of the factor of production capital (globalisation of the capital markets: increase of foreign direct investments worldwide) and more integrated international financial markets (globalisation of the financial markets: expansion above average) (*→globalisation*).

The political task of incorporating world trade rules into internationally binding treaties has to be accomplished by finding a compromise between the conflicting issues of the global interest in free trade and the national desire to shield economic sectors at home from international competition – on the grounds that the different industries, under increasing pressure from imports, see this as a threat to jobs and profit positions.

The conflict between free trade and the protectionism of national foreign trade policies is reflected in the current debate on the risks and opportunities of a global goods market.

For all the countries involved, market globalisation, which is driven by the free trade system, is leading to higher productivity, rising wages and rising real income. The sources of this prosperity increase have become accessible through multilateral trade liberalisation, since, in countries that have opened their markets to one another, exports and imports are growing simultaneously.

Growing exports create additional, relatively highly paid jobs and higher returns for business. More imports generate more indirect real income thanks to cost savings and lower prices, when local products that are relatively expensive to manufacture at home are replaced by imported goods which cost significantly less. These static efficiency gains due to free trade are reinforced by greater dynamic efficiency, since in an open world economy not only the price competition is enforced by even the competition for innovation. New technical knowledge resulting from this is circulated around the globe faster and more economically, lowering costs and prices and improving consumer supply.

In this way, globalisation offers both developed industrialised countries and advancing developing countries the potential of greater prosperity. At the same time, permanent changes to industrial, employment and income distribution procedures are inevitable. This adjustment process will produce winners and losers. But the promise of market globalisation lies in the very fact that the overall prosperity gain offered by world trade liberalisation is greater than the sum of individual prosperity losses. For this reason, compensation for those who have lost out is definitely affordable and makes it easier to cope with adjustments to the changed employment and distribution structure. This could serve as the groundwork for forward-looking solutions (the planning and development of job qualifications with a future, more flexible job market) aimed at enabling as many people as possible to reap the benefits of globalisation.

A great deal of statistical and experi-

ential material points to a positive relationship in both industrialised and developing countries between trade liberalisation and globalisation on the one hand, and increased prosperity and poverty reduction on the other. This provides empirical evidence in support of the assumption that the opportunities of globalisation are greater than the disadvantages, and that the risks are controllable.

The current international trade system is based on the agreement on the new world trade order (World Trade Organization – WTO – agreement) which came into force on 1 January 1995, officially replacing the General Agreement on Tariffs and Trade (GATT: 1947) (→*international organisations*). After that, the WTO was established in Geneva on the legal basis of the revised GATT (1994), the new services agreement (General Agreement on Trade in Services: GATS) and the TRIPS agreement (Trade-Related Aspects of Intellectual Property Rights)

GATT: 1994 contains the codification of the free trade regulations for international goods trade (industrial and agricultural goods), whereas the purpose of GATS is the liberalisation of the international services trade. All the commercial sectors regulated under the umbrella of the WTO have access to mediation procedures. A WTO member country that lodges a complaint against another contracting party for the breach of WTO regulations can force the other party to abandon the offending commercial policy measure.

The liberalisation obligations of the WTO agreement are limited by protective clauses. These regulate exceptional conditions under which member coun-

tries are permitted to restrict international competition. The most important commercial restrictions legalised in GATT: 1947 and the WTO agreement are anti-dumping compensation duties (Article 6, GATT) and interventions for the protection of the balance of payments (Article 12, GATT); these are also covered by an authorisation to implement specific protective measures in the event of an unexpected and fast increase of certain imported goods (Article 19, GATT). The resistance to reform of these ‘door openers’ for protectionist commercial policies shows that even the WTO agreement was a negotiated outcome which was supposed to find a lasting and acceptable compromise between those in support of unrestricted global trade and those in support of national protectionism.

Thus the WTO trade rules remain ambivalent because the ongoing liberalisation that would lead to a world market economy may be either promoted or hampered. Considerable untapped liberalisation potential is to be found particularly in the agricultural and services trades – perhaps important future areas for WTO reform policy.

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## Glossary

### Agenda 2000

Agenda 2000 was adopted in 1999 during the European Council convention in Berlin. The idea was to realise several goals at the same time: reform of the agricultural policy and the →*structural policy*; determination of the European Union's (EU's) financial framework for the period 2000–2006; and limitation and allocation of funding for the first phase of the Eastern expansion. Thus the EU wanted to achieve internal reforms, the financial soundness of its existing members and expenditure limitations for the Eastern expansion with just one session. Although these ambitious aims were only partly realised, Agenda 2000 still functions as a ceiling for expenditure.

### Agglomeration

Agglomeration describes the tendency of →*enterprises* to settle in a certain place in increased numbers, in order to benefit from cost and other advantages (such as industrial parks). The agglomeration of several commercial enterprises can make a specific region more attractive for consumers (for example, shopping malls), and the same holds for cultural facilities.

### Allocation

Allocation refers to the utilisation and distribution of goods and factors of production in a national economy among the different industries (What is produced, how and in what quantities?) and on the different production locations (Where is the production taking place?). In a →*market economy*, prices primarily ensure that goods and factors of production are optimally distributed in the markets (allocation function of prices).

### Annuity

Loans are usually associated with annual interest payments so that the borrowed amount is repaid after an agreed period of time. The annually payable amount consists of the interest payment and the agreed repayment; the combination of these two partial payments is called annuity.

### Arbitrage

Arbitrage is a term used in economics to explain the behaviour of the economic agents both in ordinary situations and in special markets. Someone who takes a shopping trolley to the cash till and estimates which queue has the fastest service is practising arbitrage; the aim is to save time. Someone monitoring the stock

exchange or the foreign exchange markets and finds that price differences have arisen for identical shares or foreign exchange will buy or sell shares or foreign exchange in order to make a profit out of the price difference. At the same time, this behaviour means that queues are equalised and market prices are equalised. This equalising effect of arbitrage has great significance for the →*distribution* and functioning of the →*market mechanism*.

**Bancassurance concept**

A financial market able to offer all the financial options through one supplier (loans, securities, bonds, insurance policies) is referred to as an all-finance market. Typical suppliers of all-finance do not exist. This means, for example, that non-banks (such as insurance companies) can supply financial products.

**Basel II**

Short for the Basel Agreement, adopted by the Basel Committee on Banking Supervision. The purpose of the agreement is the stabilisation of the national and international banking systems and the avoidance of competition distortions through the harmonisation of banking regulations worldwide. The first equity agreement (Basel I) came into force in 1992. Since the implementation of its regulations, banking services and the structure of the banking sector have changed considerably. The existing equity regulations had ceased to be an accurate reflection of the risk profile of the financial institutions. This is why in 1998 the Basel Committee embarked on the development of new standards. These came into force at the end of 2006. The new Basel equity agreement (Basel II) rests on three pillars: equity requirements; monitoring procedures instituted in compliance with banking supervisory regulations; and extended disclosure. Basel II has adhered to the current definition of equity as well as a minimum equity quota of 8%. Besides the market and credit risk, the operational risk is now also taken into account. The creditworthiness of the borrower has become more relevant in terms of risk calculation: instead of the undifferentiated allocation of risk weighting ratios, the creditworthiness of each debtor is judged by means of external ratings or estimations carried out internally by the bank. The second pillar regulates the monitoring procedures of the national supervisory authorities and strengthens their qualitative orientation. The third pillar extends the disclosure requirements for banks in order to make financial institutions more disciplined.

**Benchmark**

In the context of accessing the progress of an enterprise, a reference unit is chosen for the area to be analysed (internally or externally), by means of which a continual and ongoing results comparison is carried out. The best results are referred to as benchmarks and are considered as indicators. The profit centre of one's own enterprise can be a benchmark and so also can competitors serve as benchmark references. A benchmark can be an operational indicator (such as turnover, costs and market share), while in the economy the term has a very broad field of appli-

cation. This means that the interest rate of the federal borrowing, which is credited with undoubted creditworthiness, is the benchmark for securities with a fixed interest rate in the capital market.

### **Bizone**

After the Second World War, Germany was divided into three Western zones and an Eastern zone. In West Germany, on 1 January 1947, the Bizone was established in order to reorganise the economic administration of the parts of Germany under American and British occupation. As an interim solution, German administrative bodies were created in order to deal with the problems of economic supplies. The regional state parliaments named candidates for an economic affairs committee, regional representatives formed an executive committee and a directorate was selected. In April 1949, the Bizone was expanded by the area under French occupation and it became the Trizone. Associated with that was the establishment of the 'Allied High Commission' as the highest organ of control of the fledgling future Federal Republic of Germany.

### **Blue List institutes**

The federal government and the states support several economic research institutions, which are entered into the so-called Blue List. They are examined at regular intervals in order to establish whether their performance levels warrant further support. The Blue List currently comprises the following research institutions:

- *Institut für Weltwirtschaft* (Institute for the World Economy), Kiel
- *Rheinisch-Westfälisches Institut für Wirtschaftsforschung*, Essen (RWI)
- *Hamburgisches Welt-Wirtschafts-Archiv* (Hamburg Institute of International Economics), Hamburg (HWWA)
- *Institut für Wirtschaftsforschung* (Institute for Economic Research), Munich (Ifo)
- *Institut für Wirtschaftsforschung* (Institute for Economic Research), Halle
- *Deutsches Institut für Wirtschaftsforschung* (German Institute for Economic Research), Berlin (DIW)

### **Bracero Programme**

The Bracero Programme was a formal bilateral agreement between the United States and Mexico which existed from 1942 to 1964. It enabled between four and five million Mexicans to work as guest workers in the US – even if only in less-qualified or seasonal jobs, such as on Californian commercial farms. As with similar programmes in Europe, the Bracero Programme failed because the guests stayed; and nothing proved to be more permanent than the immigration that had been planned as temporary.

### **Brain drain**

'Brain drain' is the term for the emigration of more highly qualified workers. Brain drains can become a problem when experts or specially trained workers

emigrate and human capital dries up in certain locations. When this happens, less qualified people who want to stay may also lose their jobs because the competitive edge has been lost, or because specific services are no longer on offer. If, for example, medical practitioners leave their place of work, this may result in a hospital having to cease its service. On the other hand, the brain drain may also mean that the incentive is created to acquire more human capital, which leads to a higher level of education. Also, the remittances of the emigrants and the possibility that they may return home later have to be taken into account.

**Casuistic**

This describes a method of reasoning and conducting research, proceeding case by case or considering all possibilities.

**Compulsory disclosure**

Information for the public about the development of an enterprise. According to German law, the corporate form of the limited company is obliged to publish its annual accounts as well as a situation report and to make this accessible to its investors (shareholders). This compulsory disclosure ensures the transparency of the development of a corporation for the actual and potential owners of an enterprise, and makes interventions into the development of an enterprise possible – such as through the sale or acquisition of shares on the stock exchange, or the election or dismissal of members of the board of directors at a general meeting of shareholders.

**Conformity to institutional order**

In accordance with the rules and regulations of an institutional order respectively, a behaviour according to these rules. The term also means economic policy (actions and instruments) whose implementation does not disturb the effectiveness of the institutional order (for example, of a market economy).

**Convergence, converge**

This signifies the advancement to the point where conformity of opinions or aims is reached, or describes a procedure for the purpose of achieving such conformity.

**Convertibility**

Convertibility describes the right to exchange or to convert national currency into foreign currency. When this is intended for the payment of imports or exports of goods and services, it is referred to as the system of payments or the freedom of payments. If it concerns the import or export of funds (capital), it is referred to as capital transactions. In the EU Treaty, the absolute freedom of payments and of capital transactions applies (article 56) between the member states and in relation to other states (*erga omnes*). The charter of the International Monetary Fund merely contains a convertibility guarantee for the transactions of the current account, which roughly correspond to the freedom of payments (article VIII).



**Currency snake**

The European currency snake existed from 1972 until 1979. It arose when a number of European governments agreed that the level of oscillation of their currencies among each other was to be smaller than that against the dollar. This is how, in April 1972, the snake in the (dollar) tunnel began. When in March 1973 the European currencies introduced flexible exchange rates against the dollar (floating), the tunnel fell away. The European currency snake existed until March 1979, with the currencies concerned defending narrow exchange rate ranges of  $\pm 2.25\%$ .

**Deflation**

The usual explanation of deflation is that prices fall to such an extent that price levels are also negatively affected. Often even a persistent (moderate) lowering of price levels is associated with deflationary tendencies – due to falling economic activity or following a marked decrease of economic  $\rightarrow$ growth. Side effects, just as in the case of inflation, are imbalances between the goods and the monetary circulation in a national economy.

**Degree of openness**

The degree of openness of an economy describes the extent to which it is integrated in foreign trade and capital transactions. The degree of openness can be calculated as the proportion between exports and gross domestic product.

**Demand management**

The economic policy concept of demand management originates from  $\rightarrow$ Keynesianism. Its objective is to influence macroeconomic aggregates such as investments, consumption, savings, supply and demand with monetary and fiscal policy measures, in such a way that economic fluctuations are stabilised, price levels fall or rise,  $\rightarrow$ employment increases and the economy grows. Representatives of demand management believe in the feasibility of shaping the economy and in the fact that  $\rightarrow$ business cycles can be mastered ( $\rightarrow$ constructivism).

**Disparity**

Derived from the Latin word for inequality, difference.

**Distribution**

In economic terms, it refers to the distribution of  $\rightarrow$ income and assets. In business administration terms, distribution includes all activities and sales channels which serve the distribution of products among consumers.

**Dollarisation** see Euroisation**Economic agents**

These are individuals and organisations that regularly participate in the economic

process, such as private households, enterprises, the state and its institutions, and foreign countries.

### **Economic rent**

Economic rent is a passive income (effect) that a person receives without having produced a personal achievement in return. Economic theory makes a distinction between consumer and producer rents. Consumers in the market take home consumer rents when they are prepared to pay a higher price ( $p$ ) for a certain good ( $x$ ) as the price that has resulted as market equilibrium. By contrast, producers take home a producer rent when they can offer the good ( $x$ ) at a lower price ( $p$ ) because their costs are lower than the actual price in market equilibrium.

### **Economic style**

The concept of style has been borrowed from art, where different styles can be distinguished. In economics, the term describes (changing) attitudes and habits towards the economy, including ways of organisation and techniques of management of the economy, and subsequently of politics and society. Examples would include mercantilism, socialism and different types of capitalism. Thus the 'economic style' is an expression of the integration of economy into the cultural climate of a particular era or period. Pioneering researchers into economic styles are Max Weber, Werner Sombart, Artur Spietoff and Alfred →*Müller-Armack*. The concept of economic style is currently experiencing a revival as a basic category of research into economic culture.

### **EEC/EC/EU**

This terminology is characterised by many uncertainties. The EEC – the European Economic Community – was established in 1958 as a customs union with more far-reaching, including political, objectives. At the same time, the European Atomic Energy Community (Euratom) was established while the European Community for Coal and Steel (ECCS) had already been founded in 1952. In the merger treaty of 8 April 1965 the decision was taken to merge the organs of the three parts (the EEC, Euratom and the ECCS) by 1 July 1967. The result was the EC – the European Community. With the European Union Treaty of 7 February 1992 in Maastricht, the European Union (EU) was created, which came into force on 1 November 1993. The EU took over from the EC. At the end of 2003, Euratom and the ECCS were dissolved as independent bodies, leaving only the EU.

### **Egalitarianism**

The social theory of egalitarianism is in favour of, and strives for, the realisation of the highest possible degree of equality of the members of a society.

### **Empirical evidence**

This exists when a particular statement is confirmed by data or experiences from

the past. Statistical methods are often used in order to determine the accuracy or reliability of the data.

**Empirical method**

This refers to experiential knowledge based on data and other information. It presupposes investigations and includes the testing of assumptions (hypotheses) against real economic data.

**Endogenous**

This refers to developments resulting from the system itself. They are thus inherent in the system and without any external influences. The opposite of endogenous is exogenous.

**ERP special assets**

The European Recovery Programme (ERP) is a special asset of the Federal Republic of Germany. It was established in 1953 and it particularly combines the means of what used to be Marshall Plan assistance for reconstruction after the Second World War. ERP funds are available as long-term loans at favourable interest rates for the promotion of special economic regions and sectors (such as environmental protection) and of the middle classes. ERP funds were available in 1990 for the modernisation of the German Democratic Republic. ERP special assets have a revolving character since the loan repayments go to the special assets.

**Euroisation/dollarisation**

Euroisation/dollarisation entails the complete replacement of the national currency in its functions due to the behaviour of the economic agents or as the result of a political decision. If this happens, a foreign currency in the form of cash usually becomes legal tender as well as a unit of calculation and a medium of capital storage. The main causes of such a national currency exchange (currency substitution) are inflation and political uncertainties. It has been estimated that about 70% of US dollars in cash are in circulation outside the US, whereas in the case of the Deutsche Mark, this may have been 30–40%. The term euroisation is also used when a country, on joining the EU, adopts the euro as legal tender prior to its official entry into the European Monetary Union.

**European Free Trade Area (EFTA)**

The European Free Trade Area was founded in 1960 on the initiative of the United Kingdom. Its aim was both to counterbalance the European Economic Community (EEC) and to represent an alternative for countries that were not able to, or did not want to, join the European Union. The founder members were Denmark, the UK, Norway, Austria, Portugal, Sweden and Switzerland. Iceland (1970) and Finland (1985) joined later on. EFTA lost its most important members when these members joined the European Economic Community (EEC)/European Community (EC): 1973 Denmark and the UK; 1986 Portugal; 1995

Finland, Austria and Sweden. While the free trade area likewise removed internal customs duties and trade barriers, it differed from the customs union of the EEC in that it did not adopt a unified foreign trade regime towards third countries. Furthermore, EFTA dispensed with →*integration* and a common →*agricultural policy*.

### **European Monetary System (EMS)**

The European Monetary System (EMS) came into force in March 1979. Its precursor was the European Monetary Federation (from April 1972 onwards). The EMS was a special system of fixed exchange rates with a margin of fluctuations of 2.25% concurrently with the newly created currency basket of the European Currency Unit (ECU). After the currency crises of September 1992 and August 1993, the margin was extended to 15%. As a consequence of the European Currency Union and the adoption of the euro as the common currency by 1 January 1999, the original EMS 1 was transformed into EMS 2, and the principle of fixed exchange rates with a margin of fluctuations around a central rate relating to the euro was maintained.

### **Evolution, evolutionary**

These words describe a gradually progressive development over time. To a certain extent, the evolutionary nature of the change makes the development predictable.

### **External effects, external costs**

Economists refer to external effects when economic actors either do not have to cover all the costs they are causing (negative external effects – external costs) or when they are unable to reserve the advantages they have caused for themselves (positive external effects – external advantages). Negative external effects are the costs to the environment which are incurred when rivers and the environment are polluted without enterprises taking these effects into their cost calculations. Environmental policy has the task of preventing this kind of market failure or correcting it retrospectively (→*environmental policy: instruments*). Market failure also exists when there are positive external effects. When inventors do not receive protection by patent (meaning that anyone can benefit from their inventions), the inventors do not receive a fair reward for their achievements. This curbs the search for new technological and economic solutions.

### **Facility (credit)**

Provision of credit, usually between central banks, for foreign exchange market interventions (→*currency system and exchange rate regimes*).

### **Factors of production**

In economic theory, a distinction is made between three different factors of production: land, labour and capital. Their significance is the fact that through them, a surplus can be achieved in the process of production.

**Free trade**

This refers to the world trade system in its ideal state where there are no barriers to trade through customs duties, non-tariff-related impediments (e.g. discriminatory administrative regulations against foreign products) or quantitative restrictions. Additionally, at least a free transfer system has to be guaranteed, and ideally transactions free of capital as well. The →*world trade order* of GATT/WTO is based on a pragmatic objective: international trade liberalisation through the dismantling of barriers to trade, securing the level of liberalisation which has been achieved, transparency of existing barriers to trade, and procedures under the rule of law in the case of infringements against the mutually adopted regulations.

**Freedom of domicile**

The right to freely and internationally select the location of an enterprise. Foreign companies receive the same treatment as local ones (prohibition of discrimination).

**Freedom of establishment**

The right to choose one's location and above all one's place of work. When free movement of labour is granted, foreign workers are entitled to the same treatment as locals (ban on discrimination).

**Freiburg Ordo Circle**

This refers to a group of economists and lawyers (Walter →*Eucken*, Franz →*Böhm*, Hans Großmann-Doerth) which formed during the 1930s at the University of Freiburg. The basic idea was that in times of a progressively declining international economic system (such as the then world economic crisis), and of increasing state interventions and planning, to investigate the fundamental conditions of the economic and social institutional orders (systems interdependence). The freedom of individuals in their role as political and economic citizens is at the core. After 1945, these fundamentals played an important role when it came to putting an end to state planning and the realisation of the →*market economy* in its form as the →*social market economy* in the German Federal Republic (→*economic orders*, →*types of market economy*).

**Government/state ratio**

The proportion of government expenditure in a country's GDP.

**Gross domestic product (GDP)**

This is the term for the national product of a national economy (→*circular flow of incomes*).

**Historical School**

An economic school of thought and field of research in Germany from the mid-19th century.

**Hypertrophy**

Excessive increase due to rising demand.

**Innovation, innovator**

The introduction (or introducer) of a new item into production (technical progress) or the introduction of a new product.

**Insider trading**

Information resulting from professional activity must not be communicated to third parties since this represents undue influence on the normal market processes. The Securities Trade Act prescribes this, for example, for the staff of banks in order to prevent unfair trade practices.

**Institutions/institutional order of economy**

Economic and social structures are strongly influenced and shaped by institutions. Institutions stabilise expectations and channel human behaviour. In economic matters, the institutional framework provides orientation, scope and bounds for economic action. Institutions are not only organisations with a material structure and personnel; formal laws, rules and contracts are considered institutions, too, as well as (not written) informal rules of conduct, shared history, traditions and values, norms, standards and attitudes. All these institutions give economic behaviour a specific stamp. Thus, for the achievement of the results envisaged by society, the institutional framework, the institutional economic order, has to be deliberately shaped by corresponding order policies (for an adequate economic, social, monetary, environmental, etc. order). The modern school of institutional economics is not only compatible with the school of economic analysis and policy developed by the fathers of the social market economy but even closely linked to their order policy approach (*Ordnungstheorie/Ordnungspolitik*).

**Insolvency**

This refers to the inability to pay or the termination of payments as a consequence of the lack of liquidity of enterprises or persons.

**Issue, to issue**

Securities intended for the stock exchange are issued. Potential issuers are enterprises (usually corporations), regional corporations (federal states, countries, cities) and other government institutions or →*public enterprises*. The issue can be placed directly or via the agency of a bank or several banks (consortium of banks), which is the usual route.

**Lag**

The time between the implementation of an economic policy instrument and its effect; for example, in the case of monetary policy the lag may be one to two years.

**Laissez-faire**

French: to let do (to let go); motto of extreme → *liberalism* (laissez-faire liberalism). Demand for as little governmental interference in the economy as possible (a 'night watchman' state), since the decisions of the individual economic agents generate the best solutions, coordinated by the market.

**Macroeconomics**

As a sub-section of economic theory, macroeconomics investigates the interactions of the aggregates of a national economy (savings, consumption, balance of payments, state income and expenditure). Macroeconomic goals include → *growth*, → *distribution*, → *price level stability* and → *employment*.

**Margin tariff**

A margin describes a range (with an upper and a lower limit). If, instead of a fixed tariff, market participants have a margin prescribed to them inside which the tariff can be freely negotiated, a margin tariff is applied.

**Market conformity**

This exists when government interference into the economic mechanism does not really render the market processes less effective.

**Marshall Plan**

American Secretary of State George C. Marshall initiated the European Programme of Reconstruction for Europe after it had been destroyed by the Second World War (European Recovery Programme – ERP). The uniform aid programme was passed by the American Congress in 1948; it is also referred to as the Marshall Plan.

**Materialism**

In the philosophical doctrine of materialism all existing reality (including the soul, the spirit and the mind) is reduced to material forces or conditions (as opposed to idealism). The causes of social changes and revolutions are also exclusively attributed to altered relationships of production and exchange and not to personal convictions.

**Mennonite**

A Mennonite is a member of a popular Protestant free church that adheres to strict religious discipline and rejects military service; named after Menno Simons (1496–1561).

**Mercantilism**

This was the dominant economic policy in the Age of Absolutism (16th–18th century). Its outstanding characteristic was that the state strongly influenced the economy in order to increase prosperity and thus the power of the prince.

Preferred methods included:

- the promotion of (labour intensive) trade and industry;
- an active population policy;
- the promotion of technology;
- restrictions on imports; and
- the stimulation of exports for the purpose of achieving an active balance of trade.

### **Methodological individualism**

The philosophical view that grants the individual priority over the community.

### **Microeconomics**

As a sub-section of economics, microeconomics deals with the behaviour and the decisions of single economic agents (private households, enterprises) inside a national economy.

### **Money market papers**

Vested property rights or short-term financial transactions traded in the money market. They are contrasted with the long-term financial transactions and securities of the capital market.

### **Mont Pèlerin Society**

An international association of liberal economists. Named after Mont Pèlerin (Switzerland), where this group met for the first time in 1947.

### **Moral hazard**

The term originated in insurance. It describes the following behaviour: the insurer only knows the normal material risk but not the total risk when the insured generates an additional moral hazard. Due to a lack of information and opportunities for control, the insurer is unable to separate and attribute the two risks, with the effect that the insurance premium for everybody is increased. A textbook case in the field of motor accident insurance is when, in the event of damage, minor repairs are included in the claim despite these not having been caused by the accident. Where large, anonymous insurance companies (health insurance) or public social services with partial redistribution (welfare state) are concerned, a number of different attitudes arise, including: 'one does not continually want to be a net contributor', 'everyone does it', and 'honesty doesn't pay'. This creates attitudes of 'moral hazard', which add to the demand for services and make these systems more expensive. The method of choice against this trend is increased consideration of the relationship between individual risk and rate of contribution; the personal contribution as an element of the principle of the causative agent. One example: 'When it comes to mandatory insurance, are injuries caused by a sport recognised as dangerous, a private risk or a general risk of the community?'



**Moral suasion and policy of influence**

This is a qualitative economic policy instrument. Its aim is to influence the behaviour of the economic agents through reasoning. Moral suasion is successful in cases when the representative of the economic policy could also intervene by using harsher instruments.

**Municipal factor**

This term is mostly used in association with trade tax. Trade tax is arrived at by multiplying the nationally standardised trade tax (tax assessment rate) with a percentage agreed by the municipality (municipal factor). The product is the actually applicable tax rate. The levied rate can make a difference of several hundred per cent.

*Ordnungspolitik/Ordnungstheorie* see Institutions/institutional order of economy

**Paradigm**

A thought pattern, a model. A set of statements that are considered to be true.

**Polluter-pays principle**

The principle of the responsible party in environmental protection. The responsible party covers the costs it has incurred.

**Portfolio**

The term is derived from the word *portefeuille* (bag with many partitions). It is used to describe the composition of capital assets, for example their form (such as cash, term deposits, bearer bonds, shares and land), and their proportions in order to satisfy the different levels of readiness to take risks and expectations of returns.

**Principal-agent approach/theory**

This can arise in a limited company (where the principal is the owner and the agent is management) and in a democracy (principal: the voter; agent: the government, the politician). The model deals with the problems of cooperation and dependency of two individuals who are responsible for the success of an action. The individual who decides on what action to take (the agent) can maximise his or her own benefit, but not necessarily that of the other party (the principal). For this reason, the other party will try to influence the choice of action. Here, problems arise primarily from a lack of information, the costs of drawing up the contract and differing attitudes of the cooperating individuals towards maximising benefits. Thus it is assumed that a social optimum is no longer automatically generated through the market. Examples are relationships between the owner and the manager of an enterprise or the voters and politicians of a party. In a public limited company (plc), the management has an information advantage over the shareholder, and this can lead to the agent's advantage over the principal when it comes to realising their respective aims.

**Principle of equivalence**

The idea here is that service and counter-service must be of equal value. The principle of equivalence finds application in many areas of the economy. Example: to establish how a service is to be remunerated and how, in any pension insurance scheme, to relate pension pay-outs to contributions.

**Property rights**

Property rights (rights of ownership) determine the allocation of legal claims between individuals, e.g. for resources. These are not necessarily formal, legal rights of ownership. A distinction must be made here between the various forms of rights to use, the right to carry out alterations or modifications, the right to derive profits or losses as well as the right of disposal. The less concretely these rights are distributed among different individuals, the less efficient is the process of production itself and its results ( $\rightarrow$ property).

**Protectionism**

This describes a world trade order in which private and above all government measures (customs duties, non-tariff-related obstacles, quantitative restrictions) restrict the international exchange of goods and services. The ideal situation without such obstacles is free trade. The implementation of protectionist measures in the payments system and capital transactions is referred to as control of capital movement and foreign exchange control. Restrictions on the free choice of the place of work abroad are referred to as restricted freedom of labour movement. This similarly applies when the freedom of establishment for companies is abolished or is subjected to controls which apply only to foreigners. The  $\rightarrow$ *European Economic and Monetary Union* aims to establish a situation free of discrimination and protectionism.

**Public choice school/theory**

This concerns the analysis of the public decision-making process. Key is the relationship between the citizens and the public collective decisions that are not market related. Issues involved are:

- calculation of the requirement of public goods;
- the determination of an optimal budget;
- when a budget should be financed through taxes or borrowings; and
- how to determine the optimal size of collective entities for decision-making.

**Rational principle**

The principle for economic acting. The rational principle describes the behaviour of the economic agents according to which every activity is carried out along the lines of the rational economic principle with the aim of realising a certain economic success with the least possible utilisation of means (minimum principle); or of realising the greatest possible success of production (number of products) with a certain use of means (raw materials, working hours) (maximum principle).

**Real income and real purchasing power**

The real purchasing power of the monetary income and the income in real terms are closely associated. The income in real terms expresses the quantity of consumer goods which a consumer can acquire with a certain income. It is an indicator for the purchasing power in real terms. The real values are calculated by validating (dividing) the nominal (numerical) monetary incomes or the nominal purchasing power (purchasing power at current prices) by a price index (usually the price level of consumer prices). When the prices of consumer goods rise, the income in real terms decreases because fewer goods can be bought with a certain monetary income.

**Recession**

A recession describes a  $\rightarrow$ *business cycle* phase where a decrease of the  $\rightarrow$ *growth* of a (national) economy can be observed. It is considered to be the case when for two consecutive quarters, the GDP has manifested negative growth rates.

**Refinancing**

A loan which the credit grantor (e.g. a bank) grants not with its own means (its own capital) but with foreign means (e.g. savings deposits), has to be refinanced (financed with other means) when the depositor withdraws the deposit. Third persons make this refinancing process possible through their deposits.

**Savings deposits**

Deposits that exclusively serve the accumulation or the investment of assets are classified as savings deposits through an official document (especially the savings account).

**Shareholder value**

Shareholder or share-owner value. The shareholder value approach considers all shareholders associated with an enterprise as shareholders (owners of shares). It is the aim of the entrepreneurial policy to increase the shareholder value and thus, through entrepreneurial strategy and policy, to maximise the value of the shares or the assets of the owners of the limited company.

**Sight deposits**

Account deposits in banks and savings banks that are due at any time are called sight deposits. The best-known variety is the current account for the purpose of a cashless payment system.

**Solidarity**

A sense of fellowship, standing in for one another, closely associated. It always presupposes at least two persons. The larger the group, the less personal this sense becomes. Problems may arise concerning whether or not one can still have a sense of solidarity with the group.

**Solvency**

An enterprise is solvent if it is able to fulfil its payment obligations at any time. Solvency is the sum of the available financial means at a certain point in time.

**Subsidiarity**

Subsidiarity describes a principle of competences and responsibility in a society. It is assumed in a society that individuals and small groups (such as families) are generally able to take responsibility for their affairs (at the 'bottom' level). Decisions must be passed on to the next highest level (such as the municipality, federal state, federal government) to be solved only when they go beyond the competences of understanding, decision or solution of the 'bottom' level. A transfer is useful when the effects go far beyond one's own area of competence (external effects).

**Subsistence level**

The level of existence, degree of provision, material level of existence, usually for single persons or a family.

**Substitution**

The replacement of a good or a factor of production through another good or factor of production that yield an equal or greater benefit. Mostly these goods are qualitatively or quantitatively identical (examples: butter, margarine).

**Subsumption**

The ordering or summarising of terms under generic terms is referred to as subsumption. Terms of a narrower range are subsumed under terms of a wider range (example: the attribution of a fact to a legal norm).

**Synergy effects**

These arise when several effects, when put together, have a greater effect than could be expected from the addition of the separate effects. Mostly, effects are generated independently from one another and connect thereafter or are connected. In this way, it is possible to utilise already existing assembly lines for the manufacture of a new product. Synergy effects are particularly expected after the merger of enterprises.

**Terms of trade**

Terms of trade describe the actual trade relationship of import and export between different states or trading blocs. They are calculated by dividing the export price index by the import price index. When the prices for raw materials are strongly on the rise, the import price index increases. When, in that case, export goods prices remain unchanged, the terms of trade falls. This means that more export goods have to be offered abroad in order to be able to pay for the imported goods.

**Time deposits**

Deposits in accounts in banks or savings banks that fall due at an agreed or legally determined date are referred to as time deposits. Excluded from these are savings deposits and sight deposits (deposits for periods of less than 30 days).

**Trade-off**

A term in economics that above all describes conflicting aims. When conflicting aims are assumed between the stability of monetary value and full employment, there would be a trade-off because a higher level of  $\rightarrow$ employment could be achieved only through violation of the aim of monetary stability. This relationship is assumed in the Phillips Curve.

**Transaction, transaction costs**

In economic terms, a transaction corresponds to an exchange of goods or services. The costs associated with the agreement to engage in the corresponding exchange are described as transaction costs. They arise through the collection of information on potential trading partners and prices, and are also dependent on the time required for the collection of this information.

**Utility**

Utility describes a measure of subjective need satisfaction experienced by a consumer through the consumption of a good or a service at a particular time and place.

**Value-added chain**

The value-added chain describes the emergence of goods or services from raw materials via the stages of production to finished products. The value-added chain occurs in private enterprises (from acquisition to production to sale) and in a national economy (from raw materials to half finished products to finished products). Value-added includes the costs incurred (including the costs of machinery, labour, interest) in the course of the process of production.

**Volatility**

A term which is above all applied to exchange rate fluctuations in the foreign exchange markets. An exchange rate that in the course of the day or over a longer period of time shows significant changes in value in both directions is called a volatile rate.

**Win-win situation**

The term belongs to games theory. It describes a situation where as a result of the actions taken, two players end up in a better position than they were initially – both have won. The point of departure is that there is not only one winner (the so-called zero-sum game: the losses of one player are the gains of the other), but that throughout the game several players can achieve successes (the so-called multiple-sum game).



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## Sub-division of themes

### Basics

Alternative institutional framework – Concepts and economic orders	496
Basic economic concepts	496
Social market economy – concepts	497

### Economic policy in the social market economy

Competition: Institutional order and policy	497
Currency and monetary policy	497
Economic policy actors	498
Economic policy objectives	498
Education and research policy	498
Environmental protection and policy	498
European Union	499
Financial constitution and policy	499
International economic order and policies	500
Labour market and employment	500
Reunification	500
Social system and policy	500
Special policy areas	501

## Basics

### Alternative institutional frameworks – Concepts and economic orders

Conservatism	120
Constructivism	122
Economic orders: Theory and implementation	143
Institutional economics	267
Institutional order policy ( <i>Ordnungspolitik</i> ) and process policy	270
Interventionism	290
Keynesianism	293
Liberalism	303
Market economy	307
Market economy and public institutions	308
Monetarism	317
New economy	320
Socialism/planned economy	429
Societal foundation of economic orders	431
System(s) competition	449
Third ways: Mixed economy	454
Types of market economy	460

### Basic economic concepts

Business accountancy: Basic concepts	93
Business cycles	95
Circular flow of incomes, national income and national product	106
Concentration	114
Enterprise, plant	159
Entrepreneur, manager	161
Income	254
Individual responsibility	260
Managing and planning	305
Market mechanism	310
Markets and prices	312
Production and supply	349
Profit	350
Property	354
Social capital	389
Speculation	435
Statistics	436
Supply and demand	445



## **Social Market Economy – Concepts**

Achievement principle	80
Basic rights, the Basic Law and social market economy	89
Catholic social doctrines	100
Competition	111
Economic ethics	141
Open markets: Market entry, market exit	327
Protestant social ethics	358
Social market economy	
– An introduction	393
– Concept of man	395
– Political implementation	401
– Principles and functioning	407
– Social irenics	416

## **Economic policy in the social market economy**

### **Competition: Institutional order and policy**

Act Against Restraints of Competition	81
Deregulation	135
EU: Competition policy	190
Federal Cartel Office	227
Institutional order policy ( <i>Ordnungspolitik</i> ): Exemptions from competition rules	271
Patent system	331
Subsidies and government assistance	441

### **Currency and monetary policy**

Banking system, structure and supervision	86
Capital markets	98
Currency system and exchange rate regimes	129
European monetary policy:	
– Actors	178
– Aims and duties	179
– Instruments	180
– Strategies	182
Monetary order	318

**Economic policy actors**

Chamber system	103
Chambers of commerce and industry	104
Concerted Action and Alliance for Employment ( <i>Konzertierte Aktion/Bündnis für Arbeit</i> )	116
Council of Experts	128
European Central Bank, German Federal Bank	172
EU: Maxims for action	206
EU: Organs and institutions	208
Federal Cartel Office	227
Federal Employment Agency	229
Federal Republic ( <i>Bund</i> ), federal states ( <i>Länder</i> ) and municipalities	232
Interest groups, lobbies	276
International organisations	287
Parastatals	329
Policy consulting	334
Political parties	337
Social partners	418
Supervisory offices	443

**Economic policy objectives**

Balance of payments equilibrium	85
Conflicting aims in economic policy	118
Distribution	139
Employment	153
Growth	245
Price level stability	343
Protection of freedoms	356
Resource protection	377
Social justice (social balancing)	390

**Education and research policy**

Education and research policy	146
Education funding	148
EU: Education and research policy	192
Vocational training and further education	471

**Environmental protection and policy**

Environmental impact	163
Environmental policy	
– actors	165

– conflicting aims	167
– instruments	167
Environmental protection objectives	169
Environment-oriented management	171
Resource protection	377
Sustainability	448

## **European Union**

European Economic and Monetary Union	174
EU: Budgeting	186
EU: Enlargement	197
EU: History	202
EU: Maxims for action	206
EU: Organs and institutions	208
EU: Reforms and consolidation	
– economic aspects	211
– political aspects	214
Social market economy: In the EU	398
<i>EU: Selected Policy Areas</i>	
– EU: Agricultural policy and enlargement east	183
– EU: Competition policy	190
– EU: Education and research policy	192
– EU: Employment policy	194
– EU: Environmental policy	200
– EU: Industrial, research and technology policy	203
– EU: Regional and structural policy	217
– EU: Social policy	220
– EU: Trade policy	222
– EU: Transport policy	224

## **Financial constitutional and policy**

Financial constitution	233
Fiscal federalism	235
Privatisation	347
Public debt	361
Public enterprises	363
Public expenditure	365
Public revenue	367
Public-private partnerships	371
Tax policy	451

**International economic order and policies**

Development aid, development policy	137
Foreign trade	238
Globalisation	241
Indebtedness of developing countries	257
Integration	274
International currency system	278
International organisations	287
World trade order	474

**Labour market and employment**

Co-determination	107
Collective agreements	109
Employment policy	157
Federal Employment Agency	229
Industrial action	261
Industrial relations constitution	266
International Labour Organization	280
International migrations	283
Labour law	295
Labour market order	297
Labour market policy	300
Occupational health and safety	323
Shadow economy	385
Social partnership	419
Unemployment: Causes and effects	463
Unemployment: Social security	467

**Reunification**

Reconstruction East	373
Redemption Fund for Inherited Liabilities	375
Reunification:	
– Monetary, economic and social union	380
– Monetary union through currency conversion	383
Solidarity surtax	433
<i>Treuhand Privatisation Agency (Treuhandanstalt)</i>	458

**Social system and policy**

Accident insurance	79
Basic social security	91

Demographic development	131
Family policy	226
Health insurance	247
Housing policy	
– Old federal states ( <i>Länder</i> )	249
– New federal states ( <i>Länder</i> )	251
Nursing care insurance	321
Old-age pensions	325
Pension insurance (additional services)	333
Poverty	340
Social budget	386
Social policy	420
Social policy: International	423
Social state and welfare state	424
Social system	426
Unemployment: Social security	467
Wealth accumulation policy	473

### **Special policy areas**

Agricultural policy	83
Business cycle policy	96
Consumer policy	126
Housing policy	
– New federal states ( <i>Länder</i> )	249
– Old federal states ( <i>Länder</i> )	251
Industrial policy	263
Media policy	313
Middle class policy	316
Structural policy	439
Transport policy	456
Wealth accumulation policy	473



## Abbreviations

AI	Accident insurance
AQ	Age quotient
ARC	Act Against Restraints of Competition
ASM	Social Market Economy Action Group
CA	<i>Centesimus Annus</i>
CAP	Common agricultural policy
CDU	Christian Democratic Union
CEMR	Council of European Municipalities and Regions
CFSP	Common Foreign and Security Policy
CJI	Justice and the Interior
Comecon	Council for Mutual Economic Cooperation
CPI	Consumer price index
CPR	Committee of Permanent Representatives
CSU	Christian Social Union
DM	Deutsche Mark
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest and taxes, depreciation and amortisation ratio
EC	European Community
ECB	European Central Bank
ECCS	European Community for Coal and Steel
ECS	European Currency System
EC-T	European Community Treaty
ECU	European Currency Unit
EEC	European Economic Community
EFTA	European Free Trade Area
EIB	European Investment Bank
EMAS	Environmental Management and Auditing System
EMS	European Monetary System
EMU	European Monetary Union
EP	European Parliament
EPC	European Policy Cooperation
ERP	European Recovery Programme
ESC	Economic and Social Committee
ESCB	European System of the Central Banks
EU	European Union
EuAG	European Auditor General
EuCJ	European Court of Justice
Euratom	European Atomic Energy Community
EU-T	European Union Treaty
FCO	Federal Cartel Office
FDI	Foreign direct investment
FDP	Free Democratic Party
FEA	Federal Employment Agency
FSO	Federal Statistical Office

GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GDR	German Democratic Republic
GNI	Gross national income
GNP	Gross national product
HIPC	Heavily Indebted Poor Countries
ICT	Information and communication technologies
IFRS	International Financial Reporting Standards
ILA	International Labour Agency
ILC	International Labour Conference
ILO	International Labour Organization
IMF	International Monetary Fund
IT	Information technology
KAS	Konrad-Adenauer-Stiftung
NAFTA	North American Free Trade Association
NAP	National Action Plan
NCB	National central bank
NRR	Net reproduction rate
NRU	Natural rate of unemployment
OECD	Organisation for Economic Cooperation and Development
ÖVP	Österreichische Volkspartei
PDS	Party of Democratic Socialism
PLC	Public limited company
PP	Production potential
PPP	Public-private partnership
PRS	Poverty Reduction Strategies
QA	<i>Quadragesimo Anno</i>
R&D	Research and development
RAB	Regional Advisory Body
RN	<i>Rerum Novarum</i>
RSP	Regional and structural policy
SME	Small- and medium-sized enterprises
SPD	Social Democratic Party
SPÖ	Sozialistische Partei Österreichs
StabG	Act to Promote Economic Stability and Growth ( <i>Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft</i> )
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UK	United Kingdom
UN	United Nations
UNO	United Nations Organization
US	United States
US-GAAP	US-Generally Accepted Accounting Principles
VAT	Value added tax
WTO	World Trade Organization



## List of tables, figures and other illustrations

• Turnover in percent of the six largest companies in Germany in their respective industries, 2001–2004	82
• Percentage of employees in Germany with binding wage agreements, 1996–2006	110
• Competition and its functions in a market economy	112
• Average life expectancy in Germany, 1871–2005	132
• Average gross private household income in Germany in 2003 (€3,561) earned by assets, employment and public transfer payments	139
• Average net income of the household's main income recipient for several job positions in Germany in 2003	140
• Germany's education system – key data	147
• Private education funding in Germany	150
• Government education funding in Germany	152
• Fluctuations in the German job market, 1996 and 2005	158
• Air pollution in Germany, 1990–2004	164
• European Economic and Monetary Union (EEMU)	176
• EU Budget 2007: Resources by type of revenue	189
• Member states of the European Union and candidate countries, 2007 (map)	199
• Organs of the European Union	209
• Chronological listing of expansions and of membership applications in the EU, 1961–May 2007	212
• Vote distribution in the EU Council and the EU Parliament (EP) in terms of the Treaty of Nice	216
• Comparative prosperity in the European Union	218
• Mergers in Germany, 1973–2004	227
• Organisational chart of the Federal Cartel Office	228
• German balance of payments, 2006	239
• The expansion of world trade, 1980–2006	242
• Transnationality Index of host economies, 2002	244
• Purchasing power of one wage minute in Germany, 1960–2005	246
• Composition of total national income (Germany), 1996 and 2006	255
• Income equality: Gini Index of the last available year between 1985 and 2004	256
• Calculation of the Gini Index	257
• External debt of Heavily Indebted Poor Countries (HIPC) in 2005	258
• Rules for industrial action	262
• Brief summary of some international organisations	288
• GATT negotiations on the reduction of customs tariffs	289
• Transparency International Corruption Perceptions Index 2007	292

• Income statement of Volkswagen AG, 2005 and 2006	352
• Balance sheet of Volkswagen AG as at 31 December 2006	353
• Germany's federal and regional debts, 1950–2006	362
• General government consolidated gross debt of the EU-27 as a percentage of GDP	363
• Distribution of taxes and contributions in Germany, 1965–2006	368
• Income tax plus employee and employer social security contributions, 1998 and 2006	370
• Financial grants and subsidised investment volumes in Germany, 1990–1998	374
• Conversion rates based on a non-inflationary DM supply for the GDR	382
• Main areas of social expenditure in Germany listed by sector, 2006	387
• German social budget, 1991–2006	388
• Correlated types of justice	392
• Fundamental structure of the social market economy	408
• Germany's solidarity surtax revenue, 1991–2008	434
• German employment by industry sector, 1882–2005	439
• Development of financial aid and tax relief measures of the German federal government, 1970–2004	442
• Price formation in a commodity market	446
• Global Competitiveness Index: 2006 and 2005 comparisons	450
• Third ways: Mixed economy	454
• Types of market economy matrix	461
• Different categories of unemployment	464
• Distribution of unemployment by different groups in Germany, 1995–2005	466
• Rate of unemployment by educational background in Germany, 1991–2004	467

## Photographs

• Franz Böhm (Foto Mucke, Frankfurt/M.)	29
• Ludwig Erhard (Presse- und Informationsamt der Bundesregierung)	34
• Walter Eucken (Archiv für Christlich-Demokratische Politik der Konrad-Adenauer-Stiftung)	36
• Friedrich August von Hayek	40
• Alfred Müller-Armack (Presse- und Informationsamt der Bundesregierung)	52
• Wilhelm Röpke (Aktionsgemeinschaft Soziale Marktwirtschaft e.V.)	59
• Alexander Rüstow	63

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## Index

### Biographies and other personalities

- Adenauer, Konrad 33, 70, 72, 178, 402  
 Althaus, Paul 75  
 Armand, Louis 62
- Beckerath**, Erwin von 27-28, 68-69, 393  
 Bentham, Jeremy 304  
 Bergson, Henri 27  
**Böhm**, Franz 28-30, 50-51, 54-57, 60, 64, 304, 308, 389, 393, 485  
**Briefs**, Goetz 30-31, 297
- Croce, Benedetto 32
- De Gaulle, Charles 61-62  
**Dietze**, Constantin von 31-32, 393
- Einaudi**, Luigi 32-33  
 Engel, Ernst 83  
 Engels, Friedrich 100, 429  
**Engels**, Wolfram 33-34  
**Erhard**, Ludwig 28, 33-36, 39, 41, 50-51, 53-54, 60, 64, 66, 70-71, 77, 230, 304, 339, 344  
**Eucken**, Walter 28-29, 31-32, 36-39, 41-44, 46-51, 60, 64, 66, 70, 76, 101, 121, 174, 230, 277, 297, 304, 344, 393, 399, 431, 485
- Fourier, Charles 429  
**Frickhöffer**, Wolfgang 39-40
- Hayek**, Friedrich A. von 40-41, 122, 124, 126, 304, 307  
**Hensel**, K. Paul 42-43  
**Höffner**, Joseph Kardinal 43-45  
 Hume, David 41, 122, 304
- Jessen, Jens 27
- Kamitz**, Reinhard 33, 45, 46  
**Karrenberg**, Friedrich 47  
 Keynes, John Maynard 27, 31, 126, 293-294, 402
- Kohl, Helmut 380, 383, 405, 458  
 Lampe, Adolf 28, 31  
 Liebknecht, Karl 430  
 Locke, John 304, 448  
 Lorenz, Max 255  
**Lutz**, Friedrich A. 47-48
- Machiavelli, Niccolo 27  
 Marshall, George C. 487  
**Meyer**, Fritz W. 49-50  
 Meyerowitz, Esther Sara alias 'Christa Koch' 44  
 Michels, Robert 27  
**Miksch**, Leonhard 50-51, 393  
 Mill, John Stuart 241, 448  
 Mises, Ludwig von 304  
**Müller-Armack**, Alfred 50, 52-54, 57, 64, 70, 101, 230, 297, 304, 389, 391, 393, 394, 399, 407, 416-418, 432, 461-462, 482
- Nell-Breuning**, Oswald von 44, 53-57  
**Nipperdey**, Hans Carl 57-58
- Pope John Paul II 101  
 Pope Leo XIII 100  
 Pareto, Vilfredo 27  
 Popper, Karl R. 125, 305  
 Preiser, Erich 28
- Rawls, John 305  
 Ricardo, David 241  
**Röpke**, Wilhelm 32, 41, 58, 59-60, 64, 70, 304, 389, 391, 393, 402, 406  
**Rueff**, Jacques 33, 60-63  
**Rüstow**, Alexander 39-40, 63-65, 74-76, 304, 391, 393
- Salin, Edgar 28  
 Sax, Emil 27  
**Schiller**, Karl 40, 65-66, 403-404  
**Schleyer**, Hanns-Martin 67  
**Schmölders**, Günter 67-68

Schmoller, Gustav von 27, 120

**Schreiber**, Wilfried 68-69

Schumpeter, Joseph Alois 31, 162

Smith, Adam 41, 55, 100, 122-124, 141,  
241, 304, 307, 318, 410-411, 446

Sombart, Werner 432, 482

Sorel, Georges 27

Spiethoff, Arthur 432

**Stoltenberg**, Gerhard 70-72

**Stützel**, Wolfgang 34, 72-73

**Thielicke**, Helmut 74-75, 398

**Veit**, Otto 75-76

Weber, Alfred 39

Weber, Max 27, 52, 304, 482

**Welter**, Erich 77

Yoshida, Shigeru 33

## Themes

### A

Accident insurance 79, 324, 488  
 Accountancy, business 93, 171, 351  
 Achievement principle 80, 139, 141, 392, 412, 425, 408  
 Act Against Restraints of Competition 29, 35, 81, 82, 83, 115, 227, 229, 436  
 Act to Promote Economic Stability and Growth 66, 85, 155, 294, 344  
 Adjustment process 136, 231, 274, 414-413, 475  
 Administrative efficiency 452  
 Age quotient (AQ) 133-134  
 Agenda 2000 185, 189-190, 215, 477  
 Agglomeration 56, 286, 477  
 Agriculture 88, 90, 106, 184, 186, 202, 228 237, 264-265, 271-272, 330, 349  
 Agricultural commodity market 83-84  
 Agricultural market 224  
 Agricultural policy 83-85, 183-184, 189, 208, 214-215, 272, 421, 484  
 Agricultural produce price 183-184  
 Air pollution control 164, 170  
 Alliance for Employment 116-118, 157, 159, 419  
 Allocation 83, 91, 102, 121, 135, 172, 181, 182, 186-187, 207, 213, 230-231, 234-236, 238, 243, 251-253, 261, 265, 277, 344-345, 366, 370, 377, 407, 409, 477, 478, 490,  
 Allocation function 98, 344, 413, 477  
 Annual report 86, 94, 128-129, 211, 351  
 Annuity 376, 477  
 Arbitrage 285, 435, 477  
 ARC, *see* Act Against Restraints of Competition  
 Assistance, public *see also* Subsidies 73, 79, 84, 91-93, 138, 219-220, 248-250, 253, 264-265, 277, 280, 300-301, 329, 331, 342, 345, 373, 385-387, 412, 422, 424, 426, 428, 434, 440-441, 443, 457, 468-469, 483  
 Association for social policy 27-28, 31  
 Autonomy 39, 45, 55-56, 73, 102-103, 109, 143, 147-148, 158-159, 186, 221, 234, 261, 263-264, 330, 406, 418-419, 421, 428, 452, 454

### B

Baker Plan 259  
 Balance of payments 49, 62, 86, 156, 239-240, 279-280, 476, 487  
 Balance of payments equilibrium 48, 85-86, 114, 128, 156, 288, 412, 441  
 Balancing, social 102, 145, 257, 358, 390, 394, 403, 407, 415, 417, 423, 432  
 Bancassurance 445, 478  
 Banking system 73, 76, 86-89, 172, 478  
 Basel II 89, 478  
 Basic Law 57-58, 89-90, 103, 109-110, 158, 165, 170, 232-234, 236, 237-238, 314-315, 323, 337, 355-357, 362, 367, 379, 396, 398, 401, 408, 418, 424, 427, 433, 436  
 Basic rights 89, 215, 424  
 Basic social security 90-92, 421, 473  
 Benchmark 285, 396, 478  
 Beveridge curve 155  
 Birth rate 69, 131-133, 251, 286, 471  
 Bizone 401, 479  
 Blue List institutions 373, 479  
 Bonhoeffer Circle 31  
 Bracero Programme 283, 479  
 Brady Plan 259  
 Brain drain 285, 479  
 Bretton Woods institutions/system 48, 62, 130, 279, 287-288, 404  
 Business 29-30, 33, 76, 79-81, 87-88, 93-94, 105-106, 111-112, 119, 135-136, 159-163, 166, 169, 171-172, 191, 214, 246, 262, 264, 266, 271, 282, 308, 316, 327, 331, 351-352, 357, 365, 373, 420, 438, 445-446, 453, 457, 459, 464, 471  
 Business accountancy 93, 171, 240, 351, 384  
 Business cycles 36, 95-97, 107, 180, 240, 295, 321, 395, 404, 464-465, 481, 491  
 Business cycle policy 52, 96-98, 107, 117, 157, 294

### C

Candidate countries 198-199  
 Capital 46, 55, 80-81, 86-87, 89, 94-95, 98-100, 106-109, 112, 136, 138-139, 155,

- 158, 161, 190-191, 200, 220, 222, 226, 240-241, 243, 245, 254, 305, 312, 319, 326, 344-345, 349, 350, 354, 356, 367, 369, 382, 389, 402, 407, 409, 420, 427, 449, 473-475, 485
- Capital equipment 136, 150, 239, 254
- Capital flow(s) 243, 245, 279-280, 290
- Capital formation 138, 244, 253, 402, 473
- Capital goods 294, 350
- Capital markets 59, 71, 88, 98, 100, 150, 160, 163, 176, 192, 197, 316, 348, 361, 475, 479, 488
- Capital mobility/movement 130, 242, 274, 279-280, 490
- Capital stock 355, 389
- Capital transaction 239-240, 279-280, 480-481, 490
- Case law 295-296
- Casuistic 480
- Catholic social doctrines 54, 56, 68, 100, 310, 417
- Centrally administered/controlled/managed economy 36-38, 41-43, 52, 55, 58, 80, 125, 144, 257, 309, 393, 399, 429, 454, 460-461
- Centrally planned economy 125, 144-145, 306
- Chamber of Commerce and Industry 67, 103-105
- Chamber system 103,
- Chambers 103-106, 330, 364
- Circular flow of incomes 95, 106-107, 367, 385, 485
- Climate protection 166, 170
- Co-determination 30, 33, 68, 107-109, 135, 160, 165, 299-300, 387, 418-419, 421, 427, 441, 463
- Collective agreements 109-111, 118, 157-158, 262-263, 266, 295-296, 298-299, 300, 323, 383, 406, 463, 466, 472
- Collective principle 454-455
- Collective property 354, 460
- Commercial conflicts 85, 184
- Common agricultural policy (CAP) 184, 187
- Communication/communication technology 223, 236, 243, 277, 298, 313, 315, 320, 399
- Compensation 79, 83, 89-90, 127, 149, 154, 226, 231, 234, 235, 237, 260, 275, 299, 301, 324, 332, 375, 376, 386, 392, 414, 423, 428, 457, 475-476
- Competition 29, 34, 38, 41, 46, 51, 54, 58, 64, 71, 74, 80-81, 87, 90, 102, 111-115, 121, 127, 136, 145, 148, 156, 159, 162, 177, 185, 190-191, 194, 197, 200, 207, 213, 222, 224, 237, 243, 267, 270, 274, 277, 291, 300, 307, 312, 316, 323, 330, 333, 338, 354, 357, 384, 399, 409, 446, 449, 456, 461, 465, 473-474
- Competition failure 135, 273
- Competition law 29, 57, 228 315, 401, 408, 414
- Competitive system 37, 38, 50, 51, 265, 291, 327, 344
- Compulsory disclosure 445, 480
- Concentration 37, 88, 114-116, 137, 165, 206, 219, 229, 257, 286, 310, 315, 357, 358, 422
- Concept of man 389, 391, 395-398
- Concerted action 116-118, 163, 204, 404, 419
- Conditionality 138
- Conflicting aims 118-120, 156, 173, 333, 338, 493
- Conflicting aims, in economic policy 118, 173, 180, 335, 338, 345, 395, 418, 460
- Conflicting aims, in environmental policy 167, 379
- Conservatism 120-122
- Constitutional economics 267, 269
- Constructivism 37, 121-126, 404, 455, 481
- Consumer 32, 77, 81, 83, 92, 101, 106, 112-113, 119, 126-128, 131, 136, 154, 162, 179, 191, 207, 214, 223-224, 240-242, 253, 294, 307-308, 310, 312-313, 328-329, 346, 348, 355-356, 377, 382, 401, 405, 409-410, 415, 427, 443, 445-448, 465, 475, 477, 481-482, 491, 493
- Consumer demand 122, 154, 294
- Consumer goods 106, 228, 240, 294, 312, 349, 445, 491
- Consumer policy 126, 128
- Consumer sovereignty 127, 307, 430
- Consumption-savings method 106-107
- Convergence 176-177, 221, 339, 374, 480
- Convertibility 61-62, 175, 279, 480
- Corporations 67, 73, 103-104, 108, 117, 160-162, 203, 241, 243, 276, 289, 339, 351, 356, 433, 480, 486

- Corruption 141, 293, 308, 462, 292
- Costs 91, 94-95, 98, 107, 112, 116, 120, 135, 141, 148-149, 150-152, 156, 158-160, 166, 167, 169-170, 172, 187, 195, 200-201, 204, 207, 214, 223, 225, 232, 236, 240, 242, 248, 291, 318, 322, 328-329, 341, 346, 351, 364-366, 368, 370, 372, 383, 384, 386, 413, 428, 435, 441, 447, 451, 453, 457, 462, 472, 475, 478, 482, 484, 489, 493
- Council of Experts 34, 50, 73, 128-129, 302
- Credit 73, 86, 88, 89, 98, 351, 361-362, 445, 473, 478, 491
- Crisis 32, 48, 53, 60-63, 88-89, 123, 258, 280, 287, 298, 340, 404, 470
- Currency system and exchange rate regimes 129, 156, 278, 287, 404, 436, 484
- Currency snake 130, 202, 481
- Customer 81, 87, 93, 112, 272-273, 308, 313, 329, 352, 445, 453, 463
- Cycle analysis 106
- Cyclical unemployment 97
- D**
- Debt 91, 258-259, 348, 361-362, 369, 376, 404, 433
- Debt cancellation 259
- Decentralisation 116, 122, 201, 354
- Deflation 61-62, 173, 317, 319, 481
- Degree of openness 241, 481
- Demand 61, 83-84, 86, 93, 96-97, 120, 151, 153-154, 156-157, 158, 184, 191, 200, 213, 225, 231, 239, 250-252, 268, 269, 285, 293-294, 298, 299, 307, 310-314, 317, 326, 328, 345, 348, 357-358, 362, 366, 368-369, 377, 409, 446-447, 449, 465, 471, 486
- Demand management 395, 404, 481
- Demographic development 131, 134, 327, 406
- Deregulation 62, 135-137, 163, 224, 252, 273, 316, 324, 347, 404, 414, 458, 462
- Developed countries/nations 137-138, 244-245, 297, 475
- Development aid, development policy 137-138, 258, 288
- Disparity 123, 481
- Distribution 55-56, 71, 81, 88, 101, 112, 114, 127, 134, 137, 139, 140-141, 165, 173, 180-181, 186, 190, 216, 232, 235-236, 252, 253-255, 257, 271, 278, 285, 298, 313, 315, 328, 332, 340-341, 344, 345, 349, 357, 366, 368, 391, 395, 410-411, 414, 422, 424, 427, 429, 433, 474-475, 477-478, 481, 487
- Distribution target 137
- Dividends 98-99, 351, 352
- Domino effect 89
- E**
- Eastern European states 197-198, 382
- Economic agent(s) 64, 98, 102, 106, 139, 140, 207, 236, 254-255, 265, 269, 271-272, 293-294, 300, 306, 311, 328-329, 335, 345, 357, 387, 390, 409-415, 421, 441, 443-444, 448, 451, 477, 481, 483, 487-490
- Economic constitution 57-58, 144, 176, 291, 389, 414-415, 449
- Economic cycle(s) 95, 404
- Economic ethics 44, 141-143
- Economic fluctuations 95, 114, 481
- Economic history 30, 269, 399, 436
- Economic order 27, 31-32, 37, 38, 43, 55, 64, 70, 96, 123, 143-145, 270-271, 304, 306, 380-381, 393, 395, 407, 420, 432, 485
- Economic order, theory and implementation 143
- Economic planning 124, 125, 305-306, 429
- Economic policy, conflicting aims 118, 173, 180, 335, 338, 345, 395, 418, 460
- Economic rent 482
- Economic stabilisation 53, 56, 96-97, 208
- Economic Stability and Growth Act, *see* Act to Promote Economic Stability and Growth
- Economic style 52, 394, 432, 482
- Economic supervision 444
- Economic system 28, 34, 37, 41, 51, 55, 58-60, 74-75, 80, 89, 100-101, 109, 270-271, 287, 291, 298, 304, 337, 343, 357-358, 390, 394, 399, 400-401, 410, 430-431, 432, 448-449, 455, 485

- Economic union 174-175, 177, 275, 380, 383
- Education 90, 103, 105, 126, 137-138, 146, 148, 149, 151, 160, 162, 167, 192-194, 207, 219, 226, 246, 282, 286, 331, 340-341, 356, 371, 393, 397, 422-423, 471, 480
- Education and research policy 146, 426, 472
- Education and research policy, in the EU 192
- Education funding 127, 148, 194, 472
- Efficiency gains 347, 348, 475
- Efficiency principle 139-140
- EFTA, *see* European Free Trade Area 483
- Egalitarianism 429, 482
- Emission 98, 165, 168-172, 188, 201, 377-378, 444, 448
- Empirical evidence 476, 482
- Empirical method/research 68, 466, 470, 483
- Employment 85, 90-93, 110, 114, 128, 136, 153-156, 158-159, 162-163, 173, 180, 195, 196, 200, 205, 222-223, 227, 230, 240, 254, 265, 271, 278, 281, 282, 285, 294, 297, 300-303, 317, 324-325, 344, 366, 373, 386, 400, 402-403, 406, 412, 422, 441, 464-466, 468-470, 475
- Employment agency 229, 231
- Employment policy 157-159, 221, 231, 469
- Employment policy assignment 158
- Employment Promotion Act 230-231, 324, 467
- Employment protection 421
- Employment protection laws/legislation 226
- Endogenous 156, 483
- Engel's Law 83
- Enterprises 41, 79-82, 87-88, 98-99, 104-109, 113-115, 118, 125, 128, 141, 143, 145-146, 148-149, 151, 154, 158-163, 166-167, 171, 191-192, 195-196, 200, 204, 207-208, 213, 225, 249, 254, 265, 266, 274-275, 280, 291, 293, 306, 311-312, 320, 329, 339, 349, 350-353, 360-361, 363-364, 372, 375-376, 380, 384, 406, 410, 425, 430, 435, 442-443, 449, 458-460, 464, 471, 477-478, 480, 482, 484-486, 488-489, 491-492, 493
- Entrepreneur 47, 113, 146, 161-163, 169, 260, 273, 349, 460
- Environmental goods 168, 377-379
- Environmental impact 163, 166, 379, 457
- Environmental policy 105, 164-166, 169-171, 201, 379, 414, 484
- Environmental policy, actors 165, 379
- Environmental policy, conflicting aims 167, 379
- Environmental policy, instruments 167-170, 484
- Environmental pollution 141, 170, 201
- Environmental problem 166
- Environmental protection objectives 169, 172, 293, 448
- Environment-oriented management 171, 200, 413
- Equal treatment 220, 422
- Equalisation 86, 213, 240, 280, 330, 375, 455
- Equity 93-94, 99, 353, 478
- Equivalence principle *see* Principle of equivalence
- ERP special assets 330, 373, 483, 487
- Euroisation 483
- European Central Bank 35, 46, 172, 174-176, 178-179, 183, 197, 208-209, 319, 343, 346, 369, 399
- European Economic and Monetary Union 46, 61, 174, 176, 193, 196, 203, 213, 384, 399, 414, 490
- European Free Trade Area 483
- European monetary policy 173, 177, 207, 319
- European monetary policy, actors 178-180
- European monetary policy, aims and duties 179
- European monetary policy, instruments 173, 180
- European monetary policy, strategies 182
- European monetary system 61, 71, 130, 175, 279, 319, 484
- European Parliament 178, 187-189, 196, 198-199, 202, 207-210, 224, 399
- European Union 90, 105, 165, 169, 185, 217, 233, 235, 275, 284, 290, 296, 309, 330, 340, 365, 383, 442,
- European Union Treaty 187, 198, 203, 207, 215, 222, 400, 480
- Euro system 172-173, 179-183



- EU, agricultural policy 85, 183-185, 207, 223
- EU, budgeting 185-186, 189, 368
- EU, competition policy 83, 190,
- EU, education and research policy 192
- EU, employment policy 194, 196-197
- EU, enlargement 177, 185, 190, 197-200, 211, 214, 219, 225
- EU, environmental policy 200-201
- EU, history 202-203
- EU, industrial, research and technology policy 203-206, 219,
- EU, maxims for action 206-208
- EU, organs and institutions 208-211, 399
- EU, reforms and consolidation, economic aspects 211-214
- EU, reforms and consolidation, political aspects 214-217
- EU, regional and structural policy 213, 217-220, 440
- EU, social market economy *see* Social market economy in the EU
- EU social policy 220-222,
- EU trade policy 207, 222-224
- EU transport policy 224-226, 458
- Evolution 121, 124, 431, 484
- Exchange rate 40, 61-62, 89, 130, 156, 174, 176-177, 279, 288, 381, 384, 481, 493
- Exclusion principle 127, 329
- Exemptions 81, 135, 225, 271-274, 442
- Exemptions from competition rules 271-274
- External effects/costs 135, 293, 378-379, 408, 413, 441, 453, 457, 484, 492
- F**
- Facility 173, 182, 484
- Factors of production 42, 107, 112-113, 136, 213, 240, 245, 254-255, 274-275, 286, 305-306, 312, 344, 347, 349-350, 367, 407, 409-410, 447, 449, 451, 463, 477, 484
- Family policy 226-227, 253, 422, 425
- Fascism, fascist 27, 32-33
- Federal Cartel Office (FCO) 29, 82, 115, 137, 227-229
- Federal Employment Agency (FEA) 229-231, 299, 301, 472
- Federal Financial Supervisory Authority 89, 445
- Federal government/Federal Republic 28-29, 32, 43, 45, 50, 66, 68-70, 72, 75, 77, 83, 85-86, 96, 105, 109, 116-117, 121, 128-129, 147, 156, 159-160, 165, 172, 177, 226, 229, 232, 233-235, 251, 319, 330, 361-362, 365, 368, 371, 373-376, 380-386, 401, 411, 433, 442, 459, 467, 479, 485, 492
- Federal Law on Education and Training Promotion 149-152, 388
- Federal states *see* States, federal
- Federal Statistical Office (FSO) 437-438
- Federal supervisory offices 444
- Fertility 131-132
- Financial assistance 250, 277, 280, 373, 434, 443
- Financial equalisation 186, 218, 235, 238, 376, 469,
- Fiscal federalism 97, 166, 235-238, 331, 368, 406, 469,
- Fiscal policy 66, 71, 156-157, 215, 288, 294-295, 321, 481
- Five wise men 129
- Fixed (exchange rate) 73, 129-130, 174, 279-280, 287, 345, 484,
- Flexible (exchange rate) 48, 73, 86, 129-130, 156, 279, 481
- Floating (exchange rate) 40, 130
- Food 83-84, 127, 142, 168, 171, 322, 340, 442, 444,
- Foreign trade 35, 59, 67, 86, 106, 238-241, 357, 377, 402, 404, 408, 414, 481, 484
- Foreign trade policy 240
- Foreign trade theory 240, 241
- Free trade 27, 90, 174, 207, 240-241, 275, 285, 287, 290, 358, 475-476, 483, 485, 490
- Freedom of domicile 199, 485
- Freedom of establishment 191, 485
- Freedom of movement 89, 176, 191, 194, 213-214, 222, 275, 284, 393,
- Freiburg Ordo Circle/School 29, 31, 42, 44, 48-51, 60, 75, 304, 344, 393, 485
- Full employment 90, 156, 162, 205, 274, 294, 402-403, 425, 465, 468, 493
- Fully-funded 325-326
- Further education 105, 148-151, 193, 470,

**G**

- General Agreement on Tariffs and Trade (GATT) 46, 185, 222, 242, 275, 288-289, 476
- German Federal Bank 39, 76, 89, 172-174, 319, 346, 369, 380, 404, 436
- Globalisation 88, 102, 109, 136, 160, 162, 167, 192, 241-245, 273, 280, 284, 286, 290, 315, 321, 355, 398-299, 405, 409, 456, 462, 475-476
- Godesberg Programme 55, 66, 339, 403, 430
- Gold dollar standard 62
- Gold standard 27, 48, 61-62, 130, 287
- Goods production 94, 157, 349-350
- Governance cost theory 267-268
- Government ratio *see* State ratio
- Gross domestic product (GDP) 86, 95, 107, 155, 205, 244, 362, 374, 387, 218, 485, 491
- Gross national income (GNI) 95-96, 107
- Gross national product (GNP) 95, 107, 147, 187-189, 198
- Growth 62, 70, 85, 95-97, 115, 132, 135-137, 139, 155, 157, 162, 173, 177, 200, 213, 231, 241, 243, 245-246, 264-265, 280, 285, 317, 320-321, 344, 362, 366, 392, 400, 403, 433, 467, 474, 491
- Growth target 137

**H**

- Health insurance 116, 129, 207, 226, 247-249, 299, 321, 331, 387, 406, 422, 473, 488
- Heavily Indebted Poor Countries (HIPC) 258-259
- Historical school 47, 267, 485
- Housing policy 249-253, 421, 423
- Housing policy: New states 249-251
- Housing policy: Old states 251-254
- Human capital 148, 150, 218-219, 240, 246, 284, 297-298, 320, 323, 356, 407, 421, 422, 470, 473, 480
- Human dignity 43, 57, 59, 73, 323, 340, 356, 394, 396-398, 408, 411, 422, 425
- Human rights 38, 59, 198, 203, 281, 285, 288, 356-357, 396, 427, 430

Hypertrophy 486

Hysteresis theory 154, 156

**I**

- Immigration 134, 283, 285-286, 326, 342, 479
- Income 32, 59, 62, 69, 71, 80, 83-85, 90-92, 106-108, 134, 137, 139-142, 149-150, 156, 180, 185, 188, 201, 217-219, 222-223, 226, 230-231, 238, 240, 243, 245, 248-250, 252, 254-257, 260, 265, 285, 293, 301, 312-315, 340-344, 349, 354-355, 361, 366, 368-369, 371, 374, 381, 385, 400, 410-413, 420, 423-427, 433, 435, 451-455, 456, 461, 474-476
- Income distribution 56, 81, 112, 114, 139, 140, 254-256, 271, 366, 411, 474-475
- Income tax 129, 140, 152, 254, 368, 370, 433, 473,
- Indebtedness 177, 257-259, 363
- Individual responsibility 32, 38, 63, 163, 260-261, 327, 357-358, 403, 412, 427, 473
- Industrial accidents 79
- Industrial action 58, 108, 110-111, 261-263, 295, 298, 421, 463,
- Industrial policy 203, 204, 246, 263-265
- Industrial relations 54, 108, 418, 463
- Industrial relations constitution 221, 266-268, 419, 421, 422, 425,
- Industrialisation 251, 297, 331, 340, 359, 469
- Information 41, 83, 98, 105, 116, 127, 135, 146, 193, 205, 223, 230, 242, 266-268, 299, 305-307, 311, 320-321, 332, 336-338, 349-352, 355, 379, 410, 413, 418, 421, 429-430, 436-438, 469, 480, 483, 486, 488-489, 493
- Information society 205, 223, 405
- Information (and communication) technology 100, 161, 268, 298, 320
- Initiative 28, 39, 53, 59, 61, 62, 67, 72, 91, 145, 162, 168, 171, 175, 195, 206, 224, 259, 285, 345, 399, 403, 409, 415, 425, 437, 439, 461, 483,
- Innovation 73, 112, 160, 162-163, 172, 191, 197, 204-205, 221, 223, 245, 269,

- 271, 273-274, 299, 332-333, 346, 405, 409, 430, 447, 451, 455, 475, 486
- Innovator 113, 162, 269, 486
- Insider trading 445, 486
- Insider-outsider theory 154
- Insolvency 257-258, 301, 486
- Institutional economics 68, 267-269, 311, 389, 430, 432, 451, 486
- Institutional order 270, 272, 308, 387, 389, 391, 398, 399, 401, 407, 412, 415, 420, 426-427, 431, 432, 436, 480, 485
- Institutional order of economy 415, 419, 486, 489
- Institutional order policy/theory 34, 36-40, 42, 48, 49-52, 55, 64, 66, 70, 71, 73, 77, 96, 120, 128, 139, 145, 205, 207, 270-274, 306, 337, 380, 395, 408, 414, 418, 425, 431, 480
- Integration 32-33, 35, 46, 88, 90, 103, 163, 172-175, 177, 184, 186-187, 190, 200-203, 206, 210, 214, 217, 220, 223, 230, 240, 245, 273, 274-276, 280, 286-287, 290, 301-303, 328, 399, 405, 414, 468, 482, 484
- Integration process 201-202, 217, 302
- Interest groups 37, 90, 116-117, 129, 166, 276-278, 290, 291, 317, 329, 331, 336-338, 420, 438, 460, 463
- International currency systems 48, 278-280, 287, 436
- International Labour Organization 280-283, 290, 296, 419
- International migration 131, 241, 245, 283-287, 451
- International Monetary Fund (IMF) 46, 138, 257, 258-259, 280, 288, 480
- International organisations 85, 138, 222, 245, 280, 287-290, 390, 476
- Interventionism 37, 49, 63, 77, 83, 89, 97, 121, 125, 264, 270, 271-272, 290-293, 304, 309, 367, 395, 429, 440, 456, 461
- Interventions 29, 37, 56, 70, 90, 97, 107, 127, 130, 145, 194, 235, 251, 264-265, 270-273, 276, 279, 281, 291, 294, 297, 302, 304, 309, 333, 358, 365, 367, 369, 388, 412-414, 436, 439, 444, 456, 460, 476, 480, 484-485
- Investment(s) 46, 59, 71, 86-88, 93, 95, 98, 100, 136, 148-150, 158, 171, 173, 180, 187, 192, 195, 201, 218, 226, 244, 245, 246, 250, 255, 264, 268-269, 272, 280, 291, 294, 325, 326, 344, 350, 354-355, 362, 366-368, 373, 376, 390, 400, 402, 410, 413, 418, 435, 439, 440, 448-450, 452, 459, 474-475, 481
- Invisible hand 124, 307, 410, 446
- Irenics, social *see* Social irenics
- Issue 98
- Issuing bank 76, 346, 436
- J**
- Job creation 91, 153, 231, 386
- Job creation measures 301-304, 434
- Job market 62, 91, 103, 118, 126, 135, 139, 146, 153-154, 157-158, 229, 230, 285-286, 298, 302-303, 345, 421, 465, 466, 468, 475
- K**
- Keynesianism 128, 293-265, 395, 402
- L**
- Labour 43, 49, 57, 101, 108-109, 111, 120, 124, 134, 136, 139, 144, 151, 153-154, 157-158, 174, 213, 221-222, 226, 229-230, 240, 261, 262-263, 270, 280-283, 286, 291, 293, 298, 305-306, 318, 344, 349-350, 354, 390, 407, 414, 419, 425, 427, 468-470, 484, 488, 490
- Labour court 58, 111, 263, 295, 323
- Labour law 57, 295-297, 421, 463, 408
- Labour market 33, 39, 102, 129, 136, 140, 153, 154-156, 160, 175, 177, 180, 196, 213, 230-231, 241, 286, 294, 297-300, 324, 358, 402, 406, 464-465, 467, 471-472
- Labour market order 145, 159, 230, 297-300, 406, 425
- Labour market policy 157, 195, 230-231, 300-303, 421-422, 434, 472
- Labour relations 108, 419, 420
- Lag 97, 180, 345, 353, 486
- Laissez-faire 36, 38, 41, 51, 59, 75, 97, 487
- Land 42, 107, 112, 184, 214, 251, 253-254,

- 305, 349-350, 354, 367, 368, 407, 451, 458-459, 484, 489
- Länder* *see* States, federal
- Law of demand 446-447
- Liability 38, 79, 87, 161, 168-169, 247, 327, 377, 462
- Liberalism 29, 43, 45, 59, 63-64, 75, 97, 100, 102, 120, 293, 303-304, 310, 359, 389, 394, 411, 417, 487
- Liquidity 89, 93, 100, 173, 179, 181, 182, 294, 361, 377, 486
- Liquidity theory 76
- Liquidity trap 294
- Lobby *see also* Interest groups.. 105, 276-278, 316
- Location competition 162, 166, 200, 423, 449, 452
- Lockout 110, 262, 298
- Long-term unemployment 117, 135, 154, 301-302, 466, 469
- Lorenz curve 255
- Loyalty 59, 177, 462
- M**
- Maastricht, Treaty of 46, 177, 193, 203, 207, 213, 214, 221, 222, 296, 319, 320, 345, 362, 400, 482
- Macroeconomics/macro-economy 27, 43, 72f, 85, 95-98, 107, 128, 133, 135, 138, 155, 167, 197, 223, 230-231, 243, 254, 273, 287-288, 293, 302, 319, 331, 345, 349, 357, 362, 366-367, 385, 409, 411, 435, 438, 444, 456, 481, 487
- Magic square 35, 97, 155-156, 412
- Management 46, 54, 100, 161, 221, 282, 299, 358, 364, 418-419, 489
- Management, environmental 171, 172
- Manager 108, 161-162, 281, 489
- Managing and planning 305-306
- Margin tariff 225, 487
- Marginal utility 27
- Market access 207, 223-225, 275
- Market barriers 327-329
- Market behaviour 191
- Market conformity 64, 358, 395, 487
- Market economy 32, 35, 40, 47, 51-53, 63-64, 67, 90, 101, 112, 114, 128, 144-143, 169, 177, 260, 264, 270, 294, 297, 304, 306-307, 316, 354, 357, 360, 378, 389, 391-393, 404, 411, 414, 432, 456, 460-461, 462, 473, 485
- Market economy and public institutions, 308-309
- Market entry 38, 62, 135, 272, 291, 312-313, 327-329, 333, 357
- Market exit 291 327-329
- Market failure 273, 297, 379, 413, 421
- Market mechanism 101, 272, 310-312, 334, 336, 389, 409, 431
- Markets and prices 144, 306, 312-313, 357
- Marshall Plan 395, 483, 487
- Marxism / Marxist 455
- Mass privatisation 460
- Materialism 429, 487
- Maximum load theory 73
- Media policy 313-315
- Membership candidates 187, 198
- Mennonite 127, 487
- Mercantilism (ist) 421, 482, 487
- Methodological individualism (ist) 451, 488
- Microeconomics/micro-economy 72, 284, 295, 297, 488
- Middle class policy 316-317, 422, 442
- Migration 157, 213, 241, 245, 251, 283-285, 340
- Migration balance 131
- Minimum wage 111, 117, 154, 159, 281
- Mixed economy 454
- Mobility 193, 204, 206, 230-231, 236, 245, 274, 284, 286, 293, 299, 300, 407, 451, 456-457, 465, 475
- Monetarism 97, 295, 317-318, 339
- Monetary order system 48, 56, 58, 61, 62, 130, 232, 287, 318-320, 408
- Monetary policy 36, 61-63, 75-76, 85, 97, 156, 172-176, 178-180, 182-183, 208, 280, 288, 294, 317-318, 344, 346, 380, 486
- Monetary union 156, 174-176, 198, 275, 287, 346, 380, 383-384, 399
- Money market (securities/papers) 98, 180, 182-183, 488
- Money supply 97, 118, 130, 172, 178, 183, 297-298, 317-319, 382, 384
- Monopoly 30, 51, 115, 136, 159, 231, 269, 271, 312, 316, 332, 400, 413, 430, 454, 456

Mont Pèlerin Society 40, 42, 68, 488  
 Moral hazard 230, 301, 372, 488  
 Municipalities 71, 103, 116, 121, 147, 160,  
 226, 232, 365, 371, 373, 375, 442  
 Municipal factor 271, 489

## N

National income 59, 95, 106-107, 254-255,  
 293  
 National product 95, 102, 106-107, 254,  
 285, 385, 409, 412, 465, 485  
 National property 429  
 National socialism (ist) 27, 31, 44, 48, 50,  
 60, 76, 229, 287, 393, 396, 422  
 Natural rate of unemployment 154  
 Nature conservation 166, 170  
 Neo-liberal (ism) 33, 40, 53-54, 56, 64-65,  
 122, 304-305, 310, 389  
 Net borrowings 70, 361-362  
 Net income 140, 352  
 Net purchasing power 285  
 Net reproduction rate 132  
 New economy 160, 320-321, 356  
 Nobel Prize 40, 42  
 NRR, see Net reproduction rate  
 NRU, see Natural rate of unemployment  
 Nursing care insurance 221, 298, 321-323,  
 330, 386, 388, 421, 474

## O

Obstacles (barriers) to trade 186, 288, 490  
 Occupational health and safety 271, 281-  
 282, 295, 323-325, 421  
 Okun's Law 155  
 Old-age pension 69, 100, 126, 134, 226,  
 325-327, 333-334, 473  
 Oligopoly 113, 312  
 Open market (market entry, market exit)  
 38, 113, 135, 260, 272, 274, 291, 312,  
 327-329, 333, 358  
 Opportunity cost 95, 407, 409  
*Ordnungspolitik/theorie* see Institutional  
 order policy/theory  
 Ordo-liberalism 45, 50, 267  
 Output method 106-107  
 Own capital funds 89, 99, 375

## P

Paradigm 55, 404, 423, 489  
 Parastatals 232, 329-331, 347, 364, 411,  
 422, 459  
 Partners 38, 73, 80, 86, 108, 133, 156, 161,  
 185, 221, 222, 261, 268, 301, 308, 345,  
 372, 418, 420, 474, 493  
 Partnerships 108, 206, 351, 429  
 Patents/patent system 144, 228, 260, 328,  
 331-333, 356, 484  
 Pay-as-you-go 134, 325-327, 474  
 Pension 68-69, 87, 91, 129, 134, 149, 226,  
 299, 325-326, 330-334, 354, 433, 490  
 Pension insurance 134, 149, 152, 207, 232,  
 247, 322, 333-334, 370, 387, 422, 490  
 Pension system 134, 325  
 Phillips Curve 155, 344-345, 493  
 Planned economy 112, 125, 144-145, 306,  
 402, 406, 429  
 Planning 45, 122, 124-125, 144, 225-226,  
 237, 250, 265-266, 271-272, 305-306,  
 358, 402, 429, 430, 475, 485  
 Planning authority, public 430  
 Policy consulting 334-336  
 Political parties 121-122, 277, 291, 315,  
 331, 337-339, 347, 461  
 Polluter pays principle 201, 489  
 Polypoly 113, 312, 446  
 Population development 131  
 Population growth 131  
 Portfolio 99, 279-280, 284, 326, 435, 489  
 Poverty 91-91, 137, 141, 259, 325, 340-  
 343, 424  
 Poverty reduction 258, 282, 288, 476  
 Price formation 99, 129, 225, 306, 393,  
 408, 441, 446  
 Price level stability 35, 48, 85, 114, 128,  
 155, 156, 173, 180, 183, 219, 280, 318,  
 320, 327, 338, 343-346, 400, 412, 427,  
 441, 487  
 Price stability 173, 177, 179-180, 343-343,  
 346, 400  
 Price, balancing and signal effect 447  
 Principal-agent theory 268, 489  
 Principle of equivalence 369, 455, 490  
 Private property 32, 38, 56, 89, 142, 145,  
 265, 270, 298, 304, 327, 354-356, 368,  
 391, 393, 399, 401, 408, 410-411, 415,  
 439, 454

- Private residential property 250, 252-254, 473, 474
- Privatisation 72, 163, 249, 316, 331, 347-348, 365, 369, 371-372, 375-377, 383, 404, 414, 458-460
- Privatisation agency *see* *Treuhand*
- Privatisation Agency
- Process policy 37, 96, 176, 207, 264, 270-271, 306, 414, 431, 408
- Production 42, 61, 94, 96, 101, 107, 112-113, 126, 131, 135, 157, 159, 173, 186-188, 200, 213, 224, 240-245, 254-255, 267, 272-273, 291, 305-307, 312, 320-321, 327-329, 349-350, 365-366, 377-378, 407, 409-410, 413, 415, 429-430, 441, 447, 449, 453-454, 463, 474
- Production costs 158, 160, 167, 365, 368
- Production potential 96, 185, 317, 381, 442
- Production process(es) 107, 125, 134, 142, 162, 171-172, 240, 242, 254, 263-264, 286, 357, 395, 410, 473, 475
- Production and supply 113, 254, 349-350, 389
- Profit 98-99, 113, 139, 142, 160, 169, 201, 254, 261, 307, 309, 351-353, 358, 364-365, 409, 435-436, 474, 487
- Profit maximisation 55, 87, 98, 113, 139, 142, 169, 201, 254, 261, 307, 309-310, 316, 347, 350-352, 358, 364, 404, 409, 435-436, 473, 478
- Proletariat 30, 100, 125
- Property 41, 72, 102, 161, 327, 345, 354-356, 426, 458, 473
- Property rights 61
- Property rights theory 61, 267, 269, 356, 378, 408, 410-411, 488, 490
- Prosperity 34, 69-70, 98, 102, 142, 145, 173, 213, 222, 269, 274, 280-281, 285, 297, 307, 318, 321, 323, 347, 378, 390, 391, 405, 407, 411, 414-415, 418, 424, 427, 456, 461, 463, 465, 473, 475, 476, 487
- Prosperity for all 34, 405, 407, 415, 427, 461, 463
- Prosperity increase 323, 475
- Protection against unfair dismissal 73, 154, 253, 299-230, 324, 387, 421
- Protection of freedoms 356-358
- Protectionism 61, 200, 222-223, 287, 304, 475-476, 490
- Protestant 31-32, 47, 70, 74, 360, 487
- Protestant social ethics 310, 358-361, 417, 420
- Public administration 60, 103, 308, 347
- Public choice school/theory 68, 267, 269, 451, 490
- Public debt 243, 361-363, 367, 369, 377, 403
- Public enterprises 99, 135, 160, 273, 316, 330, 331, 347, 361, 363-365, 369, 440, 444, 486
- Public expenditure 62, 70, 233, 235, 273, 348, 365-368, 369, 371, 404, 412, 434
- Public revenue 186, 207, 233, 329, 347, 367-371, 392, 412, 433
- Public tasks 123, 166, 232
- Public-private partnership 206, 371-373

## Q

- Quality of the environment 168, 170
- Quadragesimo Anno* 31, 54, 101

## R

- Raiffeisen banks 87
- Rational 42, 55, 311, 328, 336, 359, 415, 490
- Rational choice 141
- Real income, purchasing power 245, 474-475, 491
- Recession 73, 95, 120, 294, 369, 404, 491
- Reconstruction East 373-375, 383, 433-434, 459
- Redemption Fund for Inherited Liabilities 330, 373, 375-377, 382, 405, 459
- Redistribution 56, 90, 102, 141, 159, 180, 215, 218, 238, 265, 270, 277-278, 338, 345, 388, 392, 411-414, 422-423, 426, 443, 473, 488
- Refinancing 173, 181, 491
- Reform programme 61, 138
- Refusal to work 110
- Regulatory principle 54-55, 379
- Rehabilitation 79, 333-334, 374
- Renewable resources 170
- Rent-seeking 277, 372, 414
- Resource protection 170, 247, 377-379, 412

- Reunification 66, 132, 375, 393, 395, 405, 433,  
 Reunification, monetary, economic and social union 380-383, 405, 460  
 Reunification, currency conversion 383-384  
 Revenue neutral 167  
 Rights of disposal 332, 356, 441
- S**
- Savings deposits 381, 491, 493  
 Scarcity 56, 112, 125, 144, 269, 285, 293, 297, 305, 307, 371, 378, 407-409, 429, 447  
 Self-help 39, 87, 103, 143, 251, 385, 428, 469  
 Shareholder value 162, 491  
 Shareholder(s) 54, 94, 99, 108, 160, 162, 268, 351, 356, 480, 489, 491  
 Shadow economy 385-386  
 Sight deposits 382, 493  
 Social assistance *see also* Basic social security 342, 386, 426, 469  
 Social balancing 102, 145, 357-358, 390-391, 394, 403, 407, 415, 417, 432  
 Social budget 386-389  
 Social capital 389-390  
 Social compensation 52, 393, 388  
 Social doctrine, Catholic 54, 56, 68, 100, 310, 417  
 Social ethics, protestant 310, 358-360, 417, 420  
 Social irenics 52, 392, 394, 416-417  
 Social justice 54, 60, 69, 72, 101, 145, 281-282, 390-392, 394, 398, 421-422, 424, 432, 463  
 Social market economy, An introduction 393-394  
 Social market economy, Concept of man 395-398  
 Social market economy, In the EU 398-401  
 Social market economy, Political implementation 334, 394, 401-407  
 Social market economy, Principles and functioning 407-416  
 Social market economy, Social irenics 416-418  
 Social partners 221, 263, 295, 418-419, 420  
 Social partnership 419-420, 421, 427  
 Social plan(ning) 122, 125, 267, 373, 376  
 Social policy 34, 38, 64, 69, 101, 105, 220-223, 230, 265, 271, 296-297, 343, 358, 387, 390, 398, 420-423, 425  
 Social policy, international 423-424  
 Social quality of a society 426  
 Social reporting 387  
 Social state 56-57, 90, 323, 358, 379, 406, 408, 411, 422, 424-426, 427-428, 436, 461  
 Social Security Code 91-92, 229-301  
 Social services 91-92, 321, 341, 386-388, 488  
 Social system 42-43, 52, 64, 113, 123, 145, 163, 207, 243, 261, 307, 344, 358, 391, 406, 408, 411, 417, 423-429, 460  
 Social union 380, 383  
 Socialism 40, 60, 63-64, 100, 145, 287, 429-430, 460, 462, 482  
 Socialism/planned economy 42, 58, 75, 89, 144, 275, 290, 306, 375, 402, 429-430, 454,  
 Social market economy 27, 33-34, 39, 47, 52, 58, 77, 109, 122, 141, 145, 203, 254, 270, 274, 297, 323, 325, 327, 354, 357, 379, 380, 386, 389, 394, 401-402, 418, 426, 432, 472, 485  
 Societal foundations of economic orders 389, 391, 431-433  
 Solidarity 44, 59, 102-103, 113, 141, 235, 248, 263, 359, 375, 392, 396, 406, 411, 412, 415, 425, 428, 433, 491  
 Solidarity strikes 263  
 Solidarity surtax 382, 433-434  
 Speculation 382, 435-436  
 Stability and Growth Act, *see* Act to Promote Economic Stability and Growth  
 Standard of living 125, 137, 190, 395, 468  
 State ratio 70, 348, 367, 404, 406, 485  
 State under the rule of law 90, 308, 448  
 State federal 71, 82, 85, 87, 92, 116, 121, 148, 153, 160, 165, 217, 232-234, 229, 235, 238, 249, 251, 315, 330, 361, 365, 373-375, 383, 386, 442, 486, 492  
 Statistics 342, 436-439, 465  
 Strike 77, 110-111, 262-263, 401

- Structural crisis 298
- Structural policy 56, 157, 187, 189-190, 215, 264-265, 275, 439-441, 442, 477
- Subsidiarity 43, 64, 65, 121, 225, 406, 427, 492
- Subsidiarity principle 87, 103-104, 120, 166, 201, 207, 219, 232, 234, 252, 298, 331, 358, 399-400, 408, 412, 415, 425, 428, 443,
- Subsidies 33, 36, 62, 71, 83-85, 104, 107, 176, 184-185, 192, 200, 207-208, 223, 225, 241, 251-254, 264-265, 276, 301, 303, 327, 329, 331, 341, 345, 348, 366, 373, 388, 408, 412, 425, 434, 439, 441-443, 452, 457, 459, 472
- Subsistence level 125, 140, 309, 340, 342-343, 420-421, 423-424, 492
- Substitution 313, 438, 492
- Subsumption 157, 253, 310, 492
- Supervisory board 55, 76, 108, 162, 277, 459
- Supervisory offices 89, 443-445
- Supplier 38, 81, 94, 98, 105, 112-113, 119, 127, 136, 149, 153, 162, 191, 223, 252, 270, 272-273, 293, 316, 345, 358, 361, 364, 366, 377, 409-410, 413, 415, 443, 445-447, 449, 456-457, 478
- Supply of (goods, factors of production) 94, 101, 114, 133, 137, 153, 168, 240, 245, 254, 307, 327, 350, 354, 364, 446-447
- Supply and demand 83, 127, 129, 139, 153, 158, 190, 230, 252, 279, 310, 312, 328, 409, 445-447, 472
- Surplus supply 154, 471
- Sustainability 121, 170, 412, 448-449
- Sustainable development 170, 355
- Synergy effects 372, 492
- Systems competition 145, 156, 162, 166, 243, 321, 401, 423, 449-451
- T**
- Tax burden 167, 219, 371, 386, 451-452
- Tax policy 329, 451-453
- Tax rate 71, 129, 406, 443, 451-453, 489
- Tax reductions 46, 97, 294, 404, 412, 433
- Tax relief 226, 250, 252, 271, 327, 443
- Telecommunications 51, 127, 135-136, 272-273, 286, 347-348, 373, 377, 400
- Term deposits 317, 489
- Terms of trade 258, 492
- Third way (s) 37, 52, 59, 145, 430, 454-456, 458
- Token strike 111, 263
- Trade union (s) 30, 39, 55, 90, 109-108, 116-117, 129, 158-159, 261-263, 276-277, 296, 298, 300, 311, 316, 329, 331, 339, 351, 360, 401, 401, 418-419, 421-422, 437, 440, 459, 463, 469
- Trade-off 97, 493
- Transaction costs 207, 268-269, 308, 318, 389, 493
- Transfer income 254
- Transition countries 460
- Transport policy 224, 456-458
- Transport services 225, 457
- Treuhand* Privatisation Agency 373, 458-460
- Treuhandanstalt* 375-376, 383-384
- Trial and error 41, 125, 410
- Types of market economy 103, 145, 393, 460-463, 485
- U**
- Ultima ratio principle 263
- Unemployment 38, 59, 73, 93, 95, 116-188, 120, 128-129, 134-135, 140-141, 153-155, 180, 195, 197, 217, 221, 230-233, 247, 264, 287, 293-294, 297-298, 300-303, 318, 323, 338, 344-345, 358, 383, 386, 403, 405-406, 412, 414, 421, 423-427, 430, 442, 463-470
- Unemployment assistance 469
- Unemployment benefit 247, 300, 322, 468
- Unemployment insurance 207, 229, 321-322, 330, 374, 433
- Unemployment rate 155, 381, 466
- Unemployment, causes and effects 463-467
- Unemployment, social security 222, 226, 299, 467-470
- Unemployment, typology 465
- United Nations 131, 281, 288-289, 296, 448, 467
- Uruguay Round 85, 185



Utilisation of resources/production  
capacity 95, 321, 366, 395, 410, 429, 451  
Utility 369, 391, 397, 410-411, 456, 493

## V

Value at risk 73  
Venture capital 99, 163  
Vocational training 42, 79, 138, 148, 151,  
193, 195, 219, 231, 245-246, 282, 296,  
301-302, 471-473  
Volatility 243, 280, 493

## W

Wage agreement 39, 110, 135-136, 155-  
156, 266, 295, 383-384, 419  
Wage negotiations 158, 437, 460  
Wage demands 117, 119, 155, 158, 351,  
384, 403-404

Wealth accumulation policy 68, 422, 427,  
439, 473-474  
Welfare state 34, 40-41, 80, 103, 123, 126,  
145, 231, 243, 278, 286, 309, 339, 343,  
358, 395, 404, 406, 412, 422, 424-245,  
427, 455-456, 488  
Win-win situation 372, 418, 493  
Works assembly 267  
Works council 30, 108, 110, 221, 266-267,  
296, 299, 383, 418  
World Bank 138, 259, 280, 288-289, 340,  
390,  
World trade 222, 242, 280, 287, 475, 485  
World trade order 86, 241, 288, 474-476,  
485, 490  
World Trade Organization (WTO) 222,  
242, 275, 288-289, 406, 476

## Y

Year-end accounts 353

## Appendix

### Selected German economic research and advisory institutions

**Arbeitsgemeinschaft Selbständiger  
Unternehmer e. V. (ASU)**

*(Working Group of Independent Entrepreneurs)*  
Reichsstraße 17  
14052 Berlin  
Tel.: 030 300650  
www.asu.de

**Aktionsgemeinschaft Soziale  
Marktwirtschaft e. V. (ASM)**

*(Social Market Economy Action Group)*  
Mohlststraße 26  
72074 Tübingen  
Tel.: 07071 550600  
www.asm-ev.de

**Europa Kolleg Hamburg  
Institut für Integrationsforschung**

*(Institute for Integration Research)*  
Windmühlenweg 27  
22607 Hamburg  
Tel.: 040 822727-0  
www.europa-kolleg-hamburg.de

**Deutsches Institut für Wirt-  
schaftsforschung e. V. (DIW)**

*(German Institute for Economic Research)*  
Königin-Luise-Straße 5  
14195 Berlin  
Tel.: 030 897890  
www.diw.de

**Forschungsstelle zum Vergleich  
Wirtschaftlicher Lenkungssysteme**

*(Institute for Comparative Economic Systems)*  
Universität Marburg  
Barfüßertor 2  
35032 Marburg  
Tel.: 06421 28-23196  
www.wiwi.uni-marburg.de/Lehrstuehle/  
VWL/WITHEO2/forschung/forschung.htm

**ifo Institut für Wirtschaftsforschung  
München e. V.**

*(Munich Institute for Economic Research)*  
Poschingerstraße 5  
81679 Munich  
Tel.: 089 92240  
www.ifo.de

**Institut der deutschen Wirtschaft e. V.  
(IW)**

*(Institute of the Germany Economy)*  
G.-Heinemann-Ufer 84-88  
50968 Cologne  
Tel.: 0221 4981510  
http://www.iwkoeln.de

**Institut Finanzen und Steuern Bonn**

*(Bonn Institute of Finance and Tax)*  
Markt 14  
53111 Bonn  
Tel.: 0228 98221-0  
http://www.ifst.de

**List Gesellschaft e. V.**

*(Cunning Society)*  
Universität Münster  
Am Stadtgraben 9  
48143 Münster  
Tel.: 0251 8322904  
http://list-gesellschaft.de

**Ludwig-Erhard-Stiftung e. V.**

*(Ludwig Erhard Foundation)*  
Johanniterstraße 8  
53113 Bonn  
Tel.: 0228 53988-0  
http://www.ludwig-erhard-stiftung.de

**Max-Planck-Institut zur Erforschung von Wirtschaftssystemen**

*(Max Planck Institute for the Research of Economic Systems)*  
 Kahlaische Straße 10  
 07745 Jena  
 Tel.: 03641 6865  
[www.mpiew-jena.mpg.de/deutsch](http://www.mpiew-jena.mpg.de/deutsch)

**Rheinisch-Westfälisches Institut für Wirtschaftsforschung e. V. (RWI)**

*(Rhenish Westphalian Institute for Economic Research)*  
 Hohenzollernstraße 1-3  
 45128 Essen  
 Tel.: 0201 81490  
[www.rwi-essen.de](http://www.rwi-essen.de)

**Wirtschafts- und Sozialwissenschaftliches Institut der Hans-Böckler-Stiftung (WSI)**

*(Hans Böckler Institute for Economics and Sociology)*  
 Bertha-von-Suttner-Platz 1  
 40227 Düsseldorf  
 Tel.: 0211 7778187  
[www.boeckler.de](http://www.boeckler.de)

**Zentrum für Europäische Wirtschaftsforschung GmbH (ZEW)**

*(Centre for European Economic Research)*  
 L 7,1  
 68161 Mannheim  
 Tel.: 0621 123501  
[www.zew.de](http://www.zew.de)

**Institut für Weltwirtschaft Kiel (IFW)**

*(Kiel Institute for World Economy)*  
 Universität Kiel  
 Düsternbrooker Weg 120  
 24105 Kiel  
 Tel.: 0431 88141  
[www.uni-kiel.de/ifw](http://www.uni-kiel.de/ifw)

**Institut für Wirtschaft und Gesellschaft Bonn e. V. (IWG)**

*(Bonn Institute for Economics and Society)*  
 Ahrstraße 45  
 53175 Bonn  
 Tel.: 0228 3720 4445  
<http://www.iwg-bonn.de>

**Institut für Wirtschaftsforschung Halle e. V.**

*(Halle Institute for Economic Research)*  
 Kleine Märkerstraße 8  
 06108 Halle/Saale  
 Tel.: 0345 775360  
<http://www.iwh.uni-halle.de>

**Hamburgisches Welt-Wirtschafts-Archiv (HWWA)**

*(Hamburg World Economy Archives)*  
 Neuer Jungfernstieg 21  
 20347 Hamburg  
 Tel.: 040 428340  
[www.hwwa.de](http://www.hwwa.de)

**Institut für Wirtschaftspolitik an der Universität zu Köln**

*(University of Cologne Institute for Economic Policy)*  
 Pohlighstraße 1  
 50969 Cologne  
 Tel.: 0221 4705347  
[www.uni-koeln.de/wiso-fak/iwp](http://www.uni-koeln.de/wiso-fak/iwp)

**Konrad-Adenauer-Stiftung e. V.**

*(Konrad Adenauer Foundation)*  
 Rathausallee 12  
 53757 Saint Augustin  
 Tel.: 02241 246 0  
 Fax: 02241 246 591

Klingelhöferstraße 23  
 10785 Berlin  
 Germany  
 Tel.: 030 26996 0  
 Fax: 030 26996 217  
<http://www.kas.de>

**Institut für Angewandte  
Wirtschaftsforschung Tübingen (IAW)**

*(Tübingen Institute for Applied Economic  
Research)*

Ob dem Himmelreich 1

72074 Tübingen

Tel.: 07071 98960

[www.uni-tuebingen.de/iaw](http://www.uni-tuebingen.de/iaw)

**Forschungsinstitut der Friedrich-  
Ebert-Stiftung e. V.**

*(Friedrich Ebert Foundation Research Institute)*

Godesberger Allee 149

53175 Bonn

Tel.: 0228 883228

[www.fes.de](http://www.fes.de)

**Walter Eucken Institut e. V.**

*(Walter Eucken Institute)*

Goethestraße 10

79100 Freiburg i. Br.

Tel.: 0761 790970

[www.eucken.de](http://www.eucken.de)

**Forschungsinstitut für  
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